



2002

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Recommended Citation

Eifler, Timothy J. (2002) "Kentucky Taxation of Banking Institutions (1802-1996): An Historical Overview," *Kentucky Law Journal*: Vol. 90 : Iss. 3 , Article 4.

Available at: <https://uknowledge.uky.edu/klj/vol90/iss3/4>

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Kentucky Taxation of Banking Institutions (1802-1996): An Historical Overview*

BY TIMOTHY J. EIFLER**

I. INTRODUCTION

Financial institutions doing business in Kentucky became subject to a new state and local tax regime effective July 15, 1996. This new regime constitutes a substantial departure from the traditional method of taxing banks that has existed in Kentucky in various forms since banking officially began in the commonwealth in 1806. As with all changes in Kentucky's system of taxing banks, this most recent change did not occur in a vacuum. This recent overhaul in the state's taxing system is a direct response to the latest change in a series of changes in federal banking law. The federal Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 ("Riegle-Neal Act")¹ itself is merely the outgrowth of the continuing evolution of the banking industry.

While clearly a major change in how Kentucky taxes banks, the Bank Franchise and Local Deposit Tax Act of 1996 is simply the most recent of the state legislature's many attempts to maintain a level playing field in the United States' dual banking system.² This current attempt at tax neutrality is best analyzed in light of Kentucky's historical attempts to make this industry pay its fair share of the public burden. To that end, this Article offers a historical overview of Kentucky's state and local taxation of banking institutions from the inception of banking in the state up to the enactment of the Riegle-Neal Act.

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¹ Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, §§ 101-03, 108 Stat. 2338, 2339-54.

² Bank Franchise and Local Deposit Tax Act of 1996, 1996 Ky. Act 254, at 999.

The history of Kentucky taxation of the banking industry can be broken into three distinct periods: (1) from the incorporation in 1802 of the first entity with banking privileges in Kentucky to the adoption of Kentucky's Third Constitution in 1850;³ (2) from the adoption of the Third Constitution to the adoption of the Fourth Constitution in 1891;⁴ and (3) from the adoption of the Fourth Constitution to 1996.⁵ Throughout these periods, shares of stock in banks were taxed in the hands of their owners. Thus, Kentucky residents owning shares in banks not domiciled in Kentucky were required to list those shares and pay property tax on them at the prevailing rate of tax on intangible personal property. The discussion below is limited to the taxation of Kentucky-domiciled banks.

II. 1802-1850: CHARTER TAXATION AND DISCRIMINATION AGAINST NATIONAL BANKS

From 1794, when Kentucky first gained statehood, through the mid-nineteenth century, all private corporations in Kentucky were formed pursuant to corporate charters granted by individual legislative enactment of the General Assembly. These charters specified the purposes for which the corporation was formed, its method of corporate governance, and its corporate powers. Banks were no exception; to organize a Kentucky bank in corporate form, its sponsors were required to seek a special charter from the General Assembly authorizing the exercise of banking powers.⁶

Banking in Kentucky unofficially began in 1802, when a number of Lexington, Kentucky businessmen obtained a charter for the Kentucky Insurance Company from the state legislature.⁷ While ostensibly formed to insure cargo on the Mississippi and Ohio rivers, the inclusion of banking privileges in its charter quickly converted the insurance company into the commonwealth's first successful banking institution.⁸ The Kentucky

³ See discussion *infra* Part II.

⁴ See discussion *infra* Part III.

⁵ See discussion *infra* Part IV-X.

⁶ The charter issued by the General Assembly would specify the activities in which the bank could engage, the interest rate that could be charged on loans and paid on deposits, the reserve ratio, the necessary capital ratio, and other items. For a discussion of chartering as opposed to general incorporation statutes, see Susan Pace Hamill, *From Special Privilege to General Utility: A Continuation of Willard Hurst's Study of Corporations*, 49 AM. U. L. REV. 81 (1999).

⁷ Act of Dec. 16, 1802, ch. 27, 1802 Ky. Acts 66, at 149; see also BASIL W. DUKE, HISTORY OF THE BANK OF KENTUCKY 10-11 (1895).

⁸ The company charter provided that "every bond, bill obligatory, or note in writing . . . shall be assignable by endorsement thereon, in like manner, and with the like effect as foreign bills of exchange now are." Act of Dec. 16, 1802, 1802

Insurance Company's charter was silent as to its method of taxation and, by default, the corporation was subject to the generally applicable property tax.⁹

In 1806, the Kentucky General Assembly chartered the Bank of Kentucky as the Commonwealth's first officially recognized bank. The legislature chartered this new bank with one million dollars of capital stock, with one-half of the bank's stock being owned by the state.¹⁰ As with the Kentucky Insurance Company, the bank's charter was silent as to taxation, subjecting the bank's corporate property to the generally applicable property tax regime.

A. 1815-1850—*Charter Taxation of State Banks*¹¹

Recognition under Kentucky tax law that the banking industry differs from general mercantile or manufacturing operations occurred in 1815 with the advent of a special bank taxation regime. A little over seven years after chartering Kentucky's first official bank, the General Assembly imposed the first bankshares tax as part of a general revision of the state's tax

Ky. Acts 66, § 20. The charter further provided that "such of the notes as are payable to bearer, shall be negotiable and assignable by delivery only." *Id.* These powers, whether unintentional or by design, converted the Kentucky Insurance Company into the commonwealth's first banking institution, the notes of which were used as currency:

It was only to make all *payable to bearer* and *all might pass by delivery*. And when vested with these properties they were so much like bank bills that it required much less genius for trade and negotiation than Lexington possessed to convert the "Kentucky Insurance Company" into a bank corporation, and thus supersede the objects of its institution, which was done, and thus Kentucky came by her first bank.

DUKE, *supra* note 7, at 11 (citing HUMPHREY MARSHALL, HISTORY OF KENTUCKY (1824)). This "mistake" was not repeated when the General Assembly chartered the Louisville Insurance Company in 1818 without such powers. *See* Act of Jan. 31, 1818, 1817-18 Ky. Acts 263, at 484.

⁹ Until 1837, Kentucky taxed limited classes of tangible property at flat rates. Intangibles were not taxed. *See* NOLLIE OLIN TAFF, HISTORY OF STATE REVENUE AND TAXATION IN KENTUCKY 45-61 (1931).

¹⁰ Act of Dec. 27, 1806, 1806 Ky. Acts, at 11.

¹¹ The Kentucky General Assembly effectively prohibited unincorporated businesses from engaging in banking activities and issuing assignable notes (so called "private banking") during this period. *See* Act of Feb. 8, 1812, 1811-12 Ky. Acts 386, at 206; *see also* Act of Feb. 14, 1820, 1819-20 Ky. Acts 593, at 980; Act of Jan. 28, 1817, 1817-18 Ky. Acts 53, at 73.

system. Shares of stock in the Bank of Kentucky, the Kentucky Insurance Company, "or any bank hereafter established" were subjected to an annual levy of \$0.25 per \$100 of value.¹² The officers of these banking institutions were to remit this tax directly to the state and charge the amount against shareholder dividends.

During the period of 1815 through 1850, this method of taxing subsequently authorized banks on their stock was specified not only by the general law, but also by more particular provisions in the banks' charters. The 1819 enactment extending the Bank of Kentucky's charter typifies the levy on bankshares during this period, requiring an annual payment of a "tax or bonus" directly to the state.¹³ Later bank charters specified tax rates between \$0.25 and \$0.50 upon each \$100 of stock issued, and reserved to the General Assembly the right to increase the specified tax rate to a maximum of \$0.50.¹⁴ According to these charters, payment of the specified tax "shall be in full of all tax or bonus" which phrase was construed to exempt the bank from all other taxes, including local real and personal

¹² Act of Jan. 31, 1814, 1813-14 Ky. Acts 151, § 13 (effective 1815); *see also* TAFF, *supra* note 9, at 103-04. This general revenue act also heralded the adoption of the ad valorem principle of taxation in Kentucky. *See id.* at 52.

¹³ Act of Feb. 6, 1819, 1818-19 Ky. Acts 380, at 693. As extended, the charter levied an annual tax of \$0.50 per \$100 beginning in December of 1821. *Id.* § 14. The General Assembly repealed this high rate of tax in 1822. Act of Dec. 5, 1822, 1822 Ky. Acts 443, § 8; *see also* TAFF, *supra* note 9, at 53.

¹⁴ *See, e.g.*, Act of Feb. 25, 1854, 1853-54 Ky. Acts 311, at 471 (Deposit Bank of Lancaster); Act of Mar. 24, 1851, 1850-51 Ky. Acts 631, at 544 (Newport Safety Fund Bank of Kentucky); Act of Mar. 20, 1851, 1850-51 Ky. Acts 508, at 446 (Deposit Bank of Danville); Act of Mar. 15, 1851, 1850-51 Ky. Acts 425, at 353 (Deposit Bank of Maysville); Act of Mar. 7, 1851, 1850-51 Ky. Acts 383, at 273 (Deposit Bank of Paris); Act of Dec. 16, 1850, 1850-51 Ky. Acts 87, at 61 (Deposit Bank of Covington); Act of Feb. 20, 1839, 1838-39 Ky. Acts 1302, at 268 (Southern Bank of Kentucky); Act of Feb. 20, 1835, 1834-35 Ky. Acts 730, at 166 (Northern Bank of Kentucky); Act of Jan. 31, 1832, 1832-33 Ky. Acts 201, at 195 (Bank of Louisville). *See also* Act of Feb. 13, 1854, 1853-54 Ky. Acts 390, at 496. Some bank charters specified the maximum \$0.50 rate, *see, e.g.*, Act of Feb. 16, 1850, 1849-50 Ky. Acts 155, at 7 (Farmers' Bank of Kentucky).

The General Assembly chartered the Bank of the Commonwealth in 1820. Act of Nov. 29, 1820, 1820 Ky. Acts 49, at 55. Unlike previous banks, the Bank of the Commonwealth was to be wholly-owned by the state and, as an agency of the state, was not subject to taxation on its shares. Its charter was later repealed in 1822, and the bank began liquidation in 1829. *See* TAFF, *supra* note 9, at 55.

property taxes.¹⁵ Again, the banks were to remit these taxes directly to the state to avoid the difficulty of collecting from individual shareholders, particularly nonresidents. This charter-specified method of assessment and collection was exclusive; shareholders would not separately be taxed on the value of those shares.¹⁶

Kentucky's first two banking institutions soon were joined by many others. Between 1818 and 1835, the General Assembly chartered¹⁷ fifty to sixty state banks. Each of these charters provided for taxation upon the bank's shares, which tax was to be remitted by the bank's officers. The rate of state taxation specified in these charters varied from \$0.375 to \$0.50 per \$100 of share value.¹⁸

¹⁵ See *Louisville Trust Co. v. City of Louisville*, 30 S.W. 991, 993 (Ky. 1895); *Franklin County Ct. v. Deposit Bank of Frankfort*, 9 S.W. 212, 215 (Ky. 1888), *overruled in part by* *Deposit Bank of Owensboro v. Daviess County*, 39 S.W. 1030 (Ky. 1897) ("If any part of the appellee's property—its franchise, its capital stock, or the shares of its capital stock, or its real property used in the operation of its business—is to be taxed in addition to the 50 cents, then it cannot be truthfully said that the payment of the 50 cents is 'in full of all tax or bonus'"); *Farmers Bank of Ky. v. Commonwealth*, 69 Ky. (6 Bush) 127 (1869) (where the charter of a bank exempts its property from all taxation, in consideration of the annual payment of a certain percentage on its capital, property of the bank cannot be taxed either by the state or the county).

¹⁶ *Johnson v. Commonwealth*, 37 Ky. (7 Dana) 338, 342-43 (1838).

¹⁷ Kentucky enacted its first general corporation law in 1854. Act of Mar. 10, 1854, ch. 1012, §§ 1-2, 1854 Ky. Acts 179, at 179-80 (granting privileges of incorporation for "carrying on any kind of manufacturing, mining, transporting, mechanical or chemical purposes or the transportation and vending of coal"). Banks could not take advantage of this method of incorporation and continued to seek special charters until the adoption of Kentucky's Fourth Constitution in 1891, and the enactment of implementing legislation in 1893. See KY. CONST. § 59, cl. 17 ("The General Assembly shall not pass local or special acts . . . [t]o grant a charter to any corporation, or to amend the charter of any existing corporation. . . ."); Act of Apr. 5, 1893, 1893 Ky. Acts 171, Art. I, II. The failure of the General Assembly to include banks in the general incorporation law of 1854 does not appear to be an oversight. Limited partnerships were first authorized by the General Assembly in 1850, and the Act specifically excluded banks from its provisions. Act of Feb. 26, 1850, ch. 189, 1850 Ky. Acts 24, at 24 (authorizing "limited partnerships, for the transaction of any agricultural, mercantile, mechanical, mining and transporting of coal, or manufacturing business" except "for the purpose of banking or making insurance"). See generally Hamill, *supra* note 6.

¹⁸ TAFF, *supra* note 9, at 55-56, 104. By the Act of Jan. 25, 1818, 1817-18 Ky. Acts 201, at 375 and the Act of Feb. 3, 1818, 1817-18 Ky. Acts 264, at 491, the General Assembly chartered forty-six "independent" banks to be completely owned

As revenue demands increased, the General Assembly steadily increased the applicable bankshares tax rate to \$0.50, the maximum allowable under the banks' charters. The general revenue law continued to levy a tax during this period "[o]n bank stock, or stock in any moneyed corporation of loan or discount . . . owned by individuals, corporations or societies."¹⁹ One year after the tax was first imposed on the Bank of Kentucky and the Kentucky Insurance Company, the General Assembly increased the rate on bankshares to \$0.375.²⁰ The general bankshares tax rate subsequently was raised to the maximum \$0.50 in 1836.²¹ The bankshares tax rate remained at the maximum \$0.50 under the general revenue law until 1886.²²

The Kentucky bankshares tax, ushered in without great fanfare, soon became the staple of taxation for the state's banking industry. Despite

by private interests. By the Act of Feb. 3, 1818, the independent banks were required to remit an annual tax of \$0.50 per \$100 of the value of issued shares. *Id.* § 13; *see also* Act of Feb. 8, 1819, 1818-19 Ky. Acts 399, at 717. Kentucky's first experiment with privately owned banks failed almost immediately. Just two years later, the General Assembly repealed their charters so

that the good people of this state be delivered in future from the baneful effects of the power and privileges granted by the law establishing independent banks in this commonwealth, which have been exercised in many instances, in the plentitude of tyranny, oppression and abuse, to the great injury of the good people of this state.

Act of Feb. 10, 1820, 1819-20 Ky. Acts 538, at 909-10; *see also* Talbot v. Warfield, 26 Ky. (3 J.J. Marsh) 83 (1829). The General Assembly once again chartered a number of banks in the 1830s as a result of President Andrew Jackson's veto in 1832 of the re-issuance of the Second Bank of the United States' charter.

¹⁹ *See* Louisville Sav. Bank v. Commonwealth, 67 Ky. 98 (1868); Commonwealth v. First Nat'l Bank of Ky., 53 Ky. 49 (1854). Trust company charters were often amended to provide that, for purposes of taxation, the company would be regarded and classed as a Kentucky bank "and shall be subject to and pay the same rate of taxes, to same parties, at same time, in same manner and for the same purposes only, as may be provided by law from time to time as the banks, doing business in this state." Act of May 15, 1886, 1885-86 Ky. Acts 1233, at 140. *See, e.g.,* Louisville Trust Co. v. City of Louisville, 30 S.W. 991, 992 (Ky. 1895).

²⁰ Act of Feb. 10, 1816, 1815-16 Ky. Acts 386, at 629. The General Assembly raised the Bank of Kentucky's rate to the maximum \$0.50 in 1821, Act of Dec. 26, 1820, 1820-21 Ky. Acts 152, § 9, and then repealed the increase, Act of Dec. 5, 1822, 1822 Ky. Acts 443, § 8.

²¹ Act of Feb. 12, 1836, 1835-36 Ky. Acts 162, at 143.

²² These increases applied to those banks whose charters authorized increases up to the maximum \$0.50. *See, e.g.,* N. Bank of Ky. v. Stone, 88 F. 413, 419 (C.C.D. Ky. 1898).

numerous challenges and various modifications, the bankshares tax proved a ready source of state tax revenue that could be collected in a simple, easily administered fashion. These attributes perhaps most readily explain why the bankshares tax was Kentucky's primary method of bank taxation from 1815 through 1995.

The bankshares tax was not only the first industry-specific method of taxing banks, but also appears to have been the first Kentucky ad valorem tax levied on intangible property. Until 1837, with the exception of the bankshares tax, Kentucky levied property taxes only on specific classes of tangible property.²³ The Act of February 23, 1837, described as "[a]n [a]ct to equalize [t]axation," expanded these taxes to include all property by requiring individuals to identify and list for taxation the value of all forms of property owned.²⁴ This equalization law also imposed the first ad valorem tax on bank deposits. Because the treatment of deposits was not specified in bank charters, Kentucky and its local governments taxed bank deposits of Kentucky residents and those deposits held in state banks or national banks operating in Kentucky to the depositors in the same fashion as other personal property.²⁵ Bank deposits did not receive special treatment for state and local tax purposes until 1917.

²³ See, e.g., Act of Jan. 31, 1814, 1813-14 Ky. Acts 151, at 110 (levying taxes on land, slaves, horses, mares, geldings, mules, jennies, wheeled carriages, billiard tables, certain licenses and bankshares).

²⁴ Act of Feb. 23, 1837, 1836-37 Ky. Acts 437, at 313 ("equalization law," required persons to list for taxation "what they should be respectively worth, from all sources . . . exclusive of the property required by law to be [specifically] listed for taxation . . . upon which the same tax should be paid. . . .").

²⁵ See generally *Northwestern Mut. Life Ins. Co. v. Commonwealth*, 175 S.W. 337 (Ky. 1915); *Commonwealth v. Helm*, 173 S.W. 389 (Ky. 1915), *aff'd*, 183 S.W. 502 (Ky. 1916); *Commonwealth v. Green*, 150 S.W. 353 (Ky. 1912); *Commonwealth v. Prudential Life Ins. Co.*, 149 S.W. 836 (Ky. 1912); *Hillman Land & Iron Co. v. Commonwealth*, 146 S.W. 776 (Ky. 1912); *Ewald Iron Co. v. Commonwealth*, 131 S.W. 774 (Ky. 1910); *Commonwealth v. W. India Oil Refining Co.*, 129 S.W. 301 (Ky. 1910), *overruled in part by Bowen v. Commonwealth*, 251 S.W. 625 (Ky. 1923); *Commonwealth v. Peebles*, 119 S.W. 774 (Ky. 1909); *Commonwealth v. Glover*, 116 S.W. 769 (Ky. 1909); *Commonwealth v. Wathen*, 104 S.W. 364 (Ky. 1907); *Commonwealth v. R.G. Dun & Co.*, 102 S.W. 859 (Ky. 1907); *Ohio Valley Tel. Co. v. City of Louisville*, 94 S.W. 17 (Ky. 1906); *Town of London v. Boyd*, 77 S.W. 931 (Ky. 1904); *Commonwealth v. Riley's Curators*, 72 S.W. 809 (Ky. 1903); *O'Callaghan's Ex'rs v. City of Owensboro*, 64 S.W. 619 (Ky. 1901); *Harting's Ex'rs v. City of Lexington*, 43 S.W. 415 (Ky. 1897); *Barbour v. Goodloe*, 6 Ky. L. Rptr. 601 (1885); *Johnson v. City of*

B. 1801-1850—Taxation of National Banks

State banking activity during the period 1801 through 1850 steadily increased during what is often called the era of “free banking.”²⁶ This

Lexington, 53 Ky. (14 B. Mon.) 648 (1854) (“The money of a citizen of Lexington, in his house, or on deposit within the city, is certainly personal property within the city, and, as such, is subject to be taxed for the use of the city.”). Until 1917, bank deposits were taxed to the depositors, not the banks holding the deposits. *Commonwealth v. Bank of Commerce*, 81 S.W. 679, 681 (Ky. 1904). Further, banks were not required to pay tax on their deposits with other banks. *See Wathen*, 104 S.W. at 364; *Deposit Bank of Owensboro v. Daviess County*, 39 S.W. 1030 (Ky. 1897).

The banks are not required to pay tax on the money deposited with them by their customers, or on amounts which represent it. Owing to the particular character of the business which they conduct, they are quasi trustees of their depositors, and under the law the depositors are required to pay the tax on the money so deposited. The banks should be required to pay tax on the shares of capital stock, on their surplus funds, undivided profits, franchises, and their real estate.

Id. at 1041. Nevertheless, the bank deposits tax was applied broadly to other depositors during this period. *See Wathen*, 104 S.W. at 365.

[W]hile a bank has a right to credit the deposit of its customer on any overdue paper of the customer which it holds, the money belongs to the customer, and is subject to his checks until the bank exercises this right; and until this is actually done the money belongs to the depositor for fiscal purposes, and is taxable in his hands just as if he owed nothing to the bank.

Id. To ensure compliance by depositors, banks were required to report their deposits. This apparently created an incentive for individuals to avoid depositing funds in banks and hoard cash, which was equally taxable, but more easily concealable in order to evade taxation. *See, e.g., Willett v. Froelich*, 90 S.W. 572, 573 (Ky. 1906) (“The only reason he gives for keeping the money in a shoe box at home is that he did not have to pay taxes on it, by which, as we understand it, he means that he could thus defraud the state of the taxes due it.”).

²⁶ The era of “free banking” generally refers to the period between the veto of the re-charter of the Second Bank of the United States in 1832 and the enactment of the National Bank Act of 1864 when banks were issuing their own notes which circulated as currency. *See Jerry W. Markham, Banking Regulation: Its History and Future*, 4 N.C. BANKING INST. 221, 226 (2000); David G. Oedel, *Why Regulate Cybermoney?*, 46 AM. U. L. REV. 1075, 1081 (1997); Lewis D. Solomon, *Local Currency: A Legal and Policy Analysis*, 5 KAN. J.L. & PUB. POL’Y 59 (1996);

growth can be attributed largely to the failure of the federal government to establish an acceptable central banking authority and the relative ease with which state bank charters were obtained.

The federal government made two early attempts to create a centralized federal bank. The first attempt was in 1791, when Congress established the Bank of the United States. This privately owned, profit-seeking institution served as the federal government's financial agent and had branches in eight states. Its omnipresence allowed the Bank of the United States to compete with state banks in attracting deposits and making loans. Because the bank was both setting the rules and competing in the marketplace, it particularly irritated state banks and was generally unpopular. The existence of a central bank was a major political issue, causing the bank to close in 1811.²⁷

Congress formed the Second Bank of the United States in 1816 to act as a central bank.²⁸ This federally chartered bank was largely in private hands but had a very special relationship with the federal government—it was a twenty percent shareholder.²⁹ The government used it as a repository for all its gold and silver, and the bank's bills were accepted as equivalent to gold for any payments to the government. Due to opposition to a central bank and to the efforts of President Andrew Jackson, the bank was closed

Note, *The New American Universal Bank*, 110 HARV. L. REV. 1310, 1318 n.55 (1997).

²⁷ For a more detailed history of the Bank of the United States and the Second Bank of the United States, see Michael Wade Strong, *Rethinking the Federal Reserve System: A Monetarist Plan for a More Constitutional System of Central Banking*, 34 IND. L. REV. 371, 372-75 (2000); see also Stacey Stritzel, Note, *The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994: Progress Toward a New Era in Financial Services Regulation*, 46 SYRACUSE L. REV. 161, 165-66 (1995).

²⁸ See Strong, *supra* note 27, at 376.

²⁹ See A. Michael Froomkin, *Reinventing the Government Corporation*, 1995 U. ILL. L. REV. 543, 551-52. Because of the unique relationship between the Second Bank of the United States and the government, the Bank was awarded special privileges. Among these privileges was that it was a storehouse for public funds. The Bank could then use these funds for its own purposes without paying interest. It could also issue bank notes and was not required to pay state taxes. Also, it was understood that Congress was not to charter any comparable financial institution. In return, the Bank was to pay a bonus of one and a half million dollars, public funds were to be transferred and payments made with no charge, and the government was to appoint five of the Bank directors. *Id.*

in 1836.³⁰ After its demise, the federal government used state banks as its repositories and was without an official central bank until 1913, when the Federal Reserve System was created.³¹

The unpopularity of the Second Bank of the United States was not lost on the Kentucky General Assembly, which made three attempts to tax the bank in an effort to drive it from the state. With the passage of the Act of February 3, 1818,³² the General Assembly required each branch of the bank to pay annually a state tax of \$5000. In lieu of this tax, the Act allowed the bank to discharge its obligations by paying either \$0.50 on each \$100 of average capital employed, or \$0.25 for each \$100 of the amount of bills under discount each year. The president, directors, and cashier of each branch were jointly and severally liable for a fine of \$10,000 for failure to pay the tax and each subordinate officer or agent of the branch was liable for a fine of \$5000 "for every such failure or refusal."³³

The Kentucky Court of Appeals, the predecessor of the Kentucky Supreme Court, held this 1818 revenue measure, along with the tax it sought to levy on the Second Bank of United States, to be unconstitutional in *Commonwealth v. Morrison*.³⁴ The court expressed its unanimous opinion that the federal act creating the bank and authorizing it to create branches in Kentucky was itself unconstitutional and that therefore the state could tax the bank as it pleased. Nevertheless, the court bowed to the then-recent ruling of the U.S. Supreme Court in *McCulloch v. Maryland*³⁵ and

³⁰ President Andrew Jackson vetoed the bank's re-charter in 1832, and the Second Bank of the United States' original charter expired by its own terms in 1836. See Steven A. Bank, *Entity Theory as a Myth in the Origins of the Corporate Income Tax*, 43 WM. & MARY L. REV. 447, 478 (2001).

³¹ Federal Reserve Act of 1913, Pub. L. No. 43, ch. 6, 38 Stat. 251 (codified as amended at 12 U.S.C. § 221-522 (2000)).

³² Act of Feb. 3, 1818, 1817-18 Ky. Acts 282, at 527.

³³ *Id.*

³⁴ *Commonwealth v. Morrison*, 9 Ky. (2 A.K. Marsh) 75 (1819).

³⁵ *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316 (1819). In this case the Court announced the doctrine of intergovernmental tax immunity and struck down a similar penalty-type tax levied by Maryland on the Second Bank of the United States, an instrumentality of the federal government. The Court left open the possibility of state taxation of national banks on their real estate and shares, stating:

This opinion does not deprive the States of any resources which they originally possessed. It does not extend to a tax paid by the real property of the bank, in common with the other real property within the State, nor to a tax imposed on the interest which the citizens of Maryland may hold in this

held the tax unconstitutional.³⁶

Within a month of the *Morrison* decision, the General Assembly again attempted to pressure the Bank through the Act of January 28, 1819.³⁷ This new Act required any person establishing an office of discount and deposit within the state, without having obtained a state charter, to pay an annual tax of \$60,000 in monthly installments of \$5000.³⁸ The Act further provided that if the tax were not paid, a state officer was authorized to break into the offices of the business to seize and thereafter sell its assets.³⁹ The tax would not be enforced against an offending bank if its president and directors notified the governor before March 4, 1819, of their intention to withdraw from the state, and the withdrawal was completed within six months of the passage of the law.⁴⁰ There is no record of the results of this Act. It appears the Act was not enforced, however, as the Second Bank of the United States continued to transact business in Kentucky until it was closed in 1836.

The last attempt by the General Assembly to tax an interest in the Second Bank of the United States occurred in 1825. The Act of January 12, 1825, required the state tax commissioners to include stock of the Bank in each shareholder's tax return and levied a tax of \$0.25 per share.⁴¹ As with the prior enactment, it is unclear whether this Act and the tax it levied were enforced.

The demise of the Second Bank of the United States in 1836 began the "free banking era" during which the only banks in Kentucky (and the United States in general) were those chartered by the states.⁴² The federal

institution, in common with other property of the same description throughout the State. But this is a tax on the operations of the bank, and is, consequently, a tax on the operation of an instrument employed by the government of the Union to carry its powers into execution. Such a tax must be unconstitutional.

Id. at 436-37. Ten years later, the Court, in *Weston v. City Council of Charleston*, 27 U.S. (2 Pet.) 449 (1829), struck down a property tax imposed on privately owned stock issued by the Second Bank of the United States. The basis for this second federal tax immunity decision was that the state tax violated the Borrowing Clause of the U.S. Constitution, Art. I, § 8, cl. 2, because it was a tax on the power "to borrow money on the credit of the United States." *Id.* at 465.

³⁶ *Morrison*, 9 Ky. at 99.

³⁷ Act of Jan. 28, 1819, 1818-19 Ky. Acts 343, at 637.

³⁸ *Id.* § 1.

³⁹ *Id.* § 2.

⁴⁰ *Id.* § 3.

⁴¹ Act of Jan. 12, 1825, 1824-25 Ky. Acts 211, at 197.

⁴² See Stritzel, *supra* note 27, at 165-66.

government neither chartered banks nor regulated the existing state banks until the passage of the first of the National Banking Acts in 1863.⁴³

III. 1850-1891

A. *Taxation of State Banks*

The adoption of Kentucky's Third Constitution in 1850 prompted a substantial revision of the Kentucky statutes, including those regarding the state's tax system.⁴⁴ As revised, the statutes left the state bankshares tax unchanged.⁴⁵ Kentucky continued to levy an annual state tax of \$0.50 per \$100 of value of bank stock, which was to be paid by the cashier of the bank.⁴⁶ Local taxes on bankshares were not authorized; each shareholder was allowed as a deduction from his otherwise taxable property ("worth from all sources") any bank stock held by him which was subject to tax in the state.⁴⁷ The collection mechanism similarly remained unchanged; the state tax on bank stock was levied upon the bank, and the shareholder was not independently liable for the tax.⁴⁸

⁴³ *Id.* at 165.

⁴⁴ See Act of Mar. 24, 1851, 1850-51 Ky. Acts 617, at 212; TAFF, *supra* note 9, at 64.

⁴⁵ Act of Mar. 24, 1851, 1850-51 Ky. Acts 617, at 212.

⁴⁶ *Id.* ch. 14, Arts. II, § 1, X.

⁴⁷ *Id.* At least one county attempted to levy its county level property tax on bankshares during this period. The former Kentucky Court of Appeals, the predecessor to the Kentucky Supreme Court, while not ruling out the possibility that counties could levy their own taxes on the shares, held that the bank could not be required to remit the tax on behalf of its shareholders because no statute authorized this method of collection for local property taxes. *Lincoln County Ct. v. Nat'l Bank of Stanford*, 8 Ky. L. Rptr. 1389, 1389 (1880).

⁴⁸ See *Louisville Sav. Bank v. Commonwealth*, 53 Ky. (14 B. Mon.) 409 (1854); but see *Trs. of Eminence v. Deposit Bank of Eminence*, 75 Ky. (12 Bush) 538 (1877) (anomalous decision holding tax to be on the bank itself).

The state taxes banks upon their capital stock, but does not do so on the ground that such stock is property owned by the banks, but as a special tax on the corporations, the amount of which is ascertained by ascertaining the amount of their capital stock. . . .

That this is a special tax, and not a tax on property, is shown not only by the fact that it is so denominated in the statute and so treated in the revenue department, but also by the fact that the same tax is imposed on shares in all the banks without regard to the condition of the bank or the value of the shares.

No other change was made until 1858, when the General Assembly expanded the bankshares tax to include the contingent (reserve) fund above the amount required by the charter, being the surplus and accumulated profits. The fund was taxable in the same fashion as capital stock at the \$0.50 rate.⁴⁹ Though paid directly by the bank, the tax on the surplus remained a liability of the shareholders. No further changes to Kentucky's taxation of state banks occurred until 1886.

B. 1865-1886: Taxes Expanded to National Banks

After the demise of the Second Bank of the United States in 1836, no new national banks were created until 1864. The federal Act of February 25, 1863 ("National Bank Act of 1863"), enacted in response to the outbreak of domestic hostilities, authorized Congress to create national banks to be chartered and regulated by the federal government and, thereby, a national currency.⁵⁰ One year later Congress amended the National Bank Act of 1863 and permitted limited state taxation of these banks.

The Act of June 3, 1864 ("National Bank Act of 1864")⁵¹ recognized that states could tax shares of stock in national banks and real estate held by national banks provided such shares and real estate were subject to no greater taxation than those of state-chartered banking institutions. The Act stated:

Provided, That nothing in this act shall be construed to prevent all the shares in any of said associations, held by any person or body corporate,

Id. at 540-41.

⁴⁹ Act of Feb. 17, 1858, 1857-58 Ky. Acts 502, § 6 (requiring the Bank of Kentucky, Northern Bank of Kentucky and the Bank of Louisville to pay \$0.50 "upon each one hundred dollars of the contingent fund now held, or [which] may hereafter accrue to said banks, over and above the amount now required to be retained by their respective charters").

⁵⁰ Act of Feb. 25, 1863, ch. 58, 12 Stat. 665 ("National Bank Act of 1863"). This Act authorized national banks to issue notes and created a mechanism for a uniform currency. The National Bank Act of 1863 also imposed a ten percent federal tax on all notes issued by state banks as an impetus for state banks to obtain federal charters and convert to national banks as well as to end the use of state bank notes as currency. The tax took effect March, 1865. The U.S. Supreme Court, in *Veazie Bank v. Fenno*, 75 U.S. (8 Wall.) 533, 548-49 (1869), declared the tax constitutional and effectively ended the issuance of new state bank notes and the use of existing notes as currency. See DUKE, *supra* note 7, at 16.

⁵¹ Act of June 3, 1864, ch. 106, 13 Stat. 99 (codified as amended at scattered sections of 12 U.S.C.).

from being included in the valuation of the personal property of such person or corporation in the assessment of taxes imposed by or under state authority at the place where such bank is located, and not elsewhere, but not at a greater rate than is assessed upon other moneyed capital in the hands of individual citizens of such state: *Provided, further*, That the tax so imposed under the laws of any state upon the shares of any of the associations authorized by this act shall not exceed the rate imposed upon the shares in any of the banks organized under authority of the state where such association is located: *Provided, also*, That nothing in this act shall exempt the real estate of associations from either state, county, or municipal taxes to the same extent, according to its value, as other real estate is taxed.⁵²

This was no concession to the states; the Act merely codified the two methods of taxing national banks left open to the states under *McCulloch v. Maryland*.⁵³ Two years earlier, in 1862, Congress had similarly codified the U.S. Supreme Court's holding in *Weston*, statutorily exempting from

⁵² *Id.* § 41.

⁵³ Congress, in 1868, amended the National Bank Act of 1864 to clarify the meaning of the words "place where the bank is located." Act of Feb. 10, 1868, ch. 7, 15 Stat. 34. The amendment made it clear that the state where the bank was located was entitled to the tax the bankshares even if owned by nonresidents:

[T]he words "place where the bank is located, and not elsewhere," in section forty-one of the "act to provide a national currency," approved June third, eighteen hundred and sixty-four, shall be construed and held to mean the State within which the bank is located; and the legislature of each State may determine and direct the manner and place of taxing all the shares of national banks located within said State, subject to the restriction that the taxation shall not be at a greater rate than is assessed upon other moneyed capital in the hands of individual citizens of such State: *And provided always*, That the shares of any national bank owned by non-residents of any State shall be taxed in the city or town where said bank is located, and not elsewhere.

Id. The U.S. Supreme Court, in *Mercantile Bank v. New York*, 121 U. S. 138, 155 (1887), identified Congress's purpose for enacting this statute as follows:

The main purpose, therefore, of Congress, in fixing limits to state taxation on investments in the shares of national banks, was to render it impossible for the State, in levying such a tax, to create and foster an unequal and unfriendly competition, by favoring institutions or individuals carrying on a similar business and operations and investments of a like character. The language of the act of Congress is to be read in the light of this policy.

state taxation all stocks, bonds, and other securities of the United States held by individuals, corporations, or associations within the United States.⁵⁴

The Kentucky General Assembly swiftly responded to Congress's limited recognition of state taxing powers, expanding the state bankshares tax to shares of stock in national banks "within Kentucky" in 1865.⁵⁵ Under this dual regime, the same tax rate was applied to shares in state and national banks. Like state banks, national banks were required to pay the tax directly to the state on behalf of their shareholders, whether resident or nonresident. In a landmark decision, the U.S. Supreme Court in *National Bank v. Commonwealth*, held that Kentucky's tax conformed to the federal act because it was imposed upon the shares of national banks and not their capital.⁵⁶ Most importantly, the Court validated Kentucky's method of

⁵⁴ Act of Feb. 25, 1862, ch. 33, § 2, 12 Stat. 345, 346 (currently codified at 31 U.S.C. § 3124). Despite the holding in *Weston* and this federal statute, the Kentucky General Assembly, in 1867, sought to levy a five percent tax on the gross annual income from interest paid on bonds issued by the federal government. Act of Mar. 11, 1867, 1867 Ky. Acts (Adj. Sess.) 2084, at 83. The former Kentucky Court of Appeals, in *Bank of Kentucky v. Commonwealth*, 72 Ky. (9 Bush) 46 (1872), dismissed the state's argument that interest on federal bonds was somehow different from the bond itself and found that the levy violated the Borrowing Clause of the U.S. Constitution.

⁵⁵ Act of Feb. 9, 1865, 1865 Ky. Acts 870, at 31. The Act provided as follows:

That it shall be the duty of the officers or managers of the banking associations which have or may hereafter be established within this state, under the act of congress, entitled "an act to provide a national currency secured by a pledge of United States bonds, and to provide for the circulation and redemption thereof," to file with the auditor of public accounts a statement, verified by the affidavit of the presiding officer or cashier of the association, showing the amount of its capital stock, and the number of shares into which the same may be divided; and it shall be the duty of such officers or managers, annually, on the first Monday in July, to pay into the public treasury of the state, in aid of the sinking fund, a tax of fifty cents on each share thereof, equal to one hundred dollars of the capital stock of said association: *Provided, however*, That if the capital stock shall at any time be increased or diminished, it shall be the duty of such association to revise and amend the statement required by this act, so as to exhibit at all times the true amount of capital stock held by such association.

Id. § 1.

⁵⁶ *Nat'l Bank v. Commonwealth*, 76 U.S. (9 Wall.) 353 (1869). The Court stated:

It has been the practice of many of the States for a long time to require of its corporations, thus to pay the tax levied on their shareholders. It is the common, if not the only, mode of doing this in all the New England States,

collection, holding that tax upon the shares in a national bank may be collected directly from the bank as agent for its shareholders.⁵⁷ The 1865 enactment failed to impose or mention other taxes. As a result, national banks were exempted from payment of taxes on any of their corporate property, real or personal.⁵⁸

For a brief two-year period, shares in national banks were taxed identically to those in state banks. In 1867, however, the General Assembly repealed the 1865 levy on national banks and subjected them to a more favorable tax structure.⁵⁹ This change likely was due to concerns about the

and in several of them the portion of this tax which should properly go as the shareholder's contribution to local or municipal taxation is thus collected by the State of the bank and paid over to the local municipal authorities. In the case of shareholders not residing in the State, it is the only mode in which the State can reach their shares for taxation. We are, therefore, of opinion that the law of Kentucky is a tax upon the shares of the stockholder.

Id. at 361.

⁵⁷ The plaintiff in the action also raised the argument that the \$0.50 rate was in excess of the Kentucky tax rate applicable to moneyed capital in the hands of individuals. While this argument had merit, the Court refused to address the issue on the basis that it had not been properly preserved. *Id.* at 363-64.

⁵⁸ See *Covington City Nat'l Bank v. City of Covington*, 21 F. 484 (C.C.D. Ky. 1884).

⁵⁹ Act of Mar. 11, 1867, 1867 Ky. Acts (Adj. Sess.) 2084, at 115-16. The Act provided as follows:

§ 1. That an annual tax, of not at a greater rate than is levied upon other money capital in the hands of individual citizens of this State, is assessed and levied on the shares of capital stock held by any person or body corporate in any bank or banking association, established or doing business, or located within, this Commonwealth, under the law of Congress of the United States of America, usually denominated National Banks: *Provided*, That the tax hereby imposed shall not exceed the rate of tax upon the shares of the capital stock of any of the banks organized under the authority of this State.

§ 2. That the president, cashier, or other chief officer of any such banks or banking associations, shall, by the first day of March in each year, report to the Auditor of Public Accounts a true and correct list and statement of the names of each stockholder, the amount of stock held by each, and the par value of each share of the capital stock in any such bank or banking association of which he is the president, cashier, or chief officer; and the Auditor shall annually, by the 10th day March in each year, notify the president, cashier, or other chief officer of any of said banks or banking associations, the amount of tax to be paid on the shares of the capital stock

rate argument in *National Bank v. Commonwealth* that the U.S. Supreme Court had refused to address. Instead of taxing national banks at \$0.50 on each share of capital stock (including surplus) as the state banks were taxed, the General Assembly required national banks established, doing business, or located within Kentucky, to pay an annual state tax on their

of such bank or banking association; and upon the payment of the amount to the State Treasurer, and the filing of his receipt therefor with the Auditor, he shall execute and deliver to the bank or banking association a quietus for the tax on the shares herein directed for that year, and the amount shall be charged to the Treasurer on account of the Sinking Fund: *Provided*, That if any such bank or banking association elect to pay said tax each year, as herein provided, to the Treasurer, the list of stockholders herein required shall be dispensed with by the Auditor for the year the payment is made: *And provided further*, That said tax is paid by the twenty-second day of March in each year.

§ 3. That on the failure, refusal, or neglect of any president, cashier, or other chief officer of any such bank or banking association, to furnish to the Auditor by the first day of March, in each year, the list and statement required to be furnished by the second section of this act, such president, cashier, or other chief officer of such bank or banking association, shall forfeit and pay to the Commonwealth of Kentucky the sum of five hundred dollars, to be recovered by motion, in the name of the Commonwealth, in the Franklin circuit court, with costs of suit and ten per cent. [D]amages; and a fee of fifty dollars shall be taxed as part of the plaintiff's costs, which the Attorney General shall be entitled to receive for his services in prosecuting said action to a recovery. And the Commonwealth shall have right to summon as a witness in said action any officer of any such bank or banking association, and cause the production in court on the trial the stock-book of said bank or banking association, and to cause to be taken therefrom the list of names and number of shares of the capital stock held by each person, corporation, or copartner, on the first day of March in each year.

§ 4. That on the failure, refusal, or neglect of any such bank or banking association to pay said tax on the shares of capital stock, as provided by this act, by the twenty-second day of March, in each year, the Auditor shall, immediately after that day, notify the proper assessor of the State revenue of the non-payment of the tax by the bank or banking association thus failing or refusing or neglecting, and shall furnish said assessor with such facts as may be within the Auditor's possession as to the number of shares, par value, and owners' names of said stock; and said assessor shall include in the tax list of each person, corporation, or copartners, the said shares of stock held by such person, corporation, or partners, on the first day of March in each year, and a tax of fifty cents upon each share of said stock shall be annually paid by the holder of said stock.

capital stock at no greater rate than was imposed on other moneyed capital in the pockets of the individual citizens—essentially the rate applicable to individuals' intangible property.⁶⁰ The General Assembly further mandated that in order to avoid violating the anti-discrimination provisions of the National Bank Act, the tax on national bankshares should not exceed the tax imposed on state banks. The tax could be assessed directly against the holders of shares in such national banks if the banks failed to properly remit payment.⁶¹ This favorable treatment of national banks subsequently was challenged by the state tax collector and found constitutional.⁶²

Twelve years later, the General Assembly once again equalized the tax burden between federal and state chartered banks. The \$0.50 levy on national bankshares was reenacted in 1878.⁶³ State and national banks were subjected equally to the bankshares levy, and the tax remained unchanged until 1886.

C. Pre-1886: The Contract Clause Controversy

The Contract Clause of the U.S. Constitution prohibits the states from enacting any law that will impair "the Obligation of Contracts."⁶⁴ This prohibition, in general, prevents the states from passing any legislation that would relieve the commitments of one party to a contract or make enforcement of a contract unreasonably difficult.⁶⁵ This restriction played a pivotal role in the development of Kentucky's system of bank taxation.

Bank charters granted by special act constitute contracts between the state, the chartered bank, and its stockholders. The U.S. Supreme Court, in 1853, recognized that a bank charter conferring a tax exemption received protection under the Contract Clause and, accordingly, the state could not

⁶⁰ *Id.* § 1.

⁶¹ *Id.* § 4.

⁶² *Commonwealth v. Covington Nat'l Bank*, 7 Ky. L. Rptr. 41 (1885).

⁶³ Act of Apr. 9, 1878, 1877-78 Ky. Acts 970, at 124. This Act curiously provided "[t]hat nothing in this act shall be considered as construing the laws as it now exists in regard to taxation of National Banks doing business in this State." *Id.* § 3.

⁶⁴ U.S. CONST. art. I, § 10 ("No State shall . . . pass any . . . Law impairing the Obligation of Contracts . . .").

⁶⁵ See Robert L. Hale, *The Supreme Court and the Contract Clause*, 57 HARV. L. REV. 512, 621, 852 (1944).

revoke the exemption by subsequent legislation.⁶⁶ Fifteen years earlier, the former Kentucky Court of Appeals had held similarly with respect to the limitations specified in the special acts chartering Kentucky banks, finding the tax provisions in bank charters to be binding on the state where subsequently enacted statutes contradicted provisions therein.⁶⁷

To restore its power of taxation over banks (and other chartered entities), the General Assembly, in the Act of February 14, 1856, reserved the right to amend, alter or revoke all charters or grants of or to corporations enacted or granted since that date ("Act of 1856").⁶⁸ This Act limited the contractual rights under state granted charters as follows:

§ 1. That all charters and grants of, or to corporations, or amendments thereof, and all other statutes, shall be subject to amendment or repeal at the will of the Legislature, unless a contrary intent be therein plainly expressed: *Provided*, That whilst privileges and franchises so granted may be changed or repealed, no amendment or repeal shall impair other rights previously vested.

....

§ 3. That the provisions of this act shall only apply to charters and acts of incorporation to be granted hereafter; and that this act shall take effect from its passage.⁶⁹

This legislative "fix" conformed to the method to address such charter problems offered by Justice Story's concurring opinion in *Dartmouth College v. Woodward*.⁷⁰ In that decision, the Supreme Court held that a state could not change the provisions of a charter after the charter had been

⁶⁶ See *Piqua Branch of State Bank of Ohio v. Knoop*, 57 U.S. (16 How.) 369 (1853) (sustaining a Contract Clause claim and invalidating a statute revoking a tax exempt tax previously granted by an Ohio bank-chartering statute).

⁶⁷ See *Johnson v. Commonwealth*, 37 Ky. (7 Dana) 338 (1838).

⁶⁸ Act of Feb. 14, 1856, 1855-56 Ky. Acts 148, at 15.

⁶⁹ *Id.*

⁷⁰ *Dartmouth Coll. v. Woodward*, 17 U.S. (4 Wheat.) 518, 712 (1819) (Story, J., concurring). Justice Story stated:

In my judgment it is perfectly clear, that any act of a legislature which takes away any powers or franchises vested by its charter in a private corporation or its corporate officers, or which restrains or controls the legitimate exercise of them, or transfers them to other persons, without its assent, is a violation of the obligations of that charter. If the legislature mean to claim such an authority, it must be reserved in the grant.

Id.

issued. At the same time, however, the Court conceded that if a state reserved the right to modify the terms of a charter either by a provision in the charter or by a general statutory scheme, a state could subsequently modify an existing charter without violating the Contract Clause. By the Act of 1856, Kentucky took advantage of this concession by the U.S. Supreme Court for charters granted or amended on or after the date of its enactment.⁷¹

National banks were unaffected by the Kentucky Act of 1856, as the provisions of the National Bank Act limited their taxation. The state chartered banks in Kentucky, however, took issue with the application of the Act of 1856 to their existing charters. State banks chartered before 1856 claimed that their charters created an irrevocable contract, and therefore, the state could tax them only as specified in those charters. Further complicating matters, not all of these banks were in the same position. It was unclear whether banks with pre-1856 charters which had been extended or renewed after February 14, 1856 were subject to the Act of 1856. It was very clear, however, that state banks initially chartered after the effective date of the Act were subject to such taxation as the state might constitutionally see proper to place upon them. These newer banks raised concerns about being subjected to local tax burdens and their inability to compete with banks protected by pre-1856 charters and threatened to reorganize as national banks to seek protection under the National Bank Act. With the view of placing the entire matter at rest, and placing all banks on an equal footing, the Kentucky legislature, in 1886, enacted the Act of May 17, 1886 ("Hewitt Act").⁷²

D. 1886-1891: The Hewitt Act

The Hewitt Act was a novel attempt to bring uniformity to Kentucky's taxation of state and national bankshares. At the time, there was substantial uncertainty as to Kentucky's power to tax banks within its borders. Four banks claimed to be subject only to limited taxation because of charters

⁷¹ A vestige of the Act of 1856 still remains in Kentucky's statutes. *See* KY. REV. STAT. ANN. [hereinafter K.R.S.] § 271B.18-050 (Michie 1989), provides that "[a]ll corporate charters granted and grants made to corporations since February 14, 1856, may be revoked by the general assembly, unless a contrary intent is plainly expressed; but no revocation or repeal shall impair other rights previously vested."

⁷² Act of May 17, 1886, 1885-56 Ky. Acts 1233, Art. II, at 140 [hereinafter Hewitt Act].

adopted prior to the Act of 1856.⁷³ Others of the remaining sixty-five state banks were asserting a like right under charters adopted since 1856, but, it was argued, they were not governed by the Act of 1856. In light of the claims of the state banks, the fifty-nine national banks doing business in Kentucky were insisting that they were subject only to the rate of taxation to which the most favored state bank was liable. The national banks argued that to tax them at a higher rate would be a discrimination in favor of the state banks prohibited by federal law. Adding to this turmoil, it was claimed that the varying rate of local taxation to which non-chartered state banks (private unincorporated banks) were subject created an inequality in taxation among banking institutions, and was driving banking capital from the localities where the tax was highest to the detriment of the public.⁷⁴

To assuage these difficulties and resolve the conflict, to secure as to all banks, state and national, a uniform and higher rate of state taxation than that existing as to other property, the Hewitt Act tendered to all incorporated and unincorporated banking institutions a new contract giving freedom from most local tax burdens if a higher state tax was voluntarily paid.⁷⁵ The taxes under this plan were optional. If the corporation gave its consent, no other state or local taxes were levied except local real property taxes. If the corporation did not accept this plan, its shares, surplus and undivided profits were to be taxed for state, county and municipal purposes at the rate imposed "on the assessed taxable property in the hands of individuals."⁷⁶ Bank-owned real estate was taxable for local purposes under either plan.⁷⁷

⁷³ The acts creating these banks are as follows: Act of Feb. 16, 1850, 1849-50 Ky. Acts 155, at 7 (Farmer's Bank); Act of Feb. 13, 1846, 1845-46 Ky. Acts 152, at 8 (Bank of Louisville); Act of Feb. 20, 1835, 1835-36 Ky. Acts 730, at 166 (Northern Bank); Act of Jan. 24, 1835, 1835-36 Ky. Acts 610, at 49 (Bank of Kentucky).

⁷⁴ Despite being subject to substantial penalties for engaging in such activities, *see supra* note 11, private unincorporated banks did operate during this period. *See infra* note 84.

⁷⁵ *See Citizens' Sav. Bank v. City of Owensboro*, 173 U.S. 636, 648-49 (1899).

⁷⁶ Hewitt Act, *supra* note 72, § 7.

⁷⁷ The Hewitt Act provided as follows:

§ 1. That shares of stock in State and National banks, and other institutions of loan or discount, and in all corporations required by law to be taxed on their capital stock, shall be taxed seventy-five cents on each share thereof, equal to one hundred dollars, or on each one hundred dollars of stock therein owned by individuals, corporations or societies, and said banks, institutions and corporations shall, in addition, pay upon each one

hundred dollars of so much of their surplus, undivided surplus, undivided profits or undivided accumulations, as exceeds an amount equal to ten per cent. of their capital stock, the same rate of taxation that is assessed upon real estate, which shall be in full of all tax, State, county and municipal. For the purpose of ascertaining such surplus, undivided profits or undivided accumulations, the Auditor may, at his option, investigate the books of such bank, institution or corporation; and any officer having in charge the affairs of such bank, institution or corporation who shall refuse, when duly called upon for the purpose, to all his books to be investigated, shall be subject to indictment in the Franklin circuit court, or the circuit court of the county wherein said bank, institution or corporation shall be located, and upon conviction, shall be fined not less than five hundred dollars and not more than one thousand dollars. The Commonwealth may, in the county wherein said bank, institution or corporation is located, institute an action in any court having civil common law jurisdiction of the amount involved for the recovery of the fine.

§ 2. The cashier of a bank, and the treasurer of any other institution or corporation, whose stock is taxed, shall, on the first day of July in each year, report to the Auditor of Public Accounts the true amount of the capital stock, the true amount of surplus, undivided profits or undivided accumulations, and how or in what said surplus, undivided profits, or undivided accumulations is invested, and pay into the Treasury the amount of tax due. If such tax be not paid, the cashier and his sureties shall be liable for the same and twenty per cent. upon the amount, and any State bank, institution or corporation shall thereby forfeit the privilege of its charter. The officer making the report shall attach thereto the following affidavit, to which he shall make oath before some officer authorized to administer oaths: "I, _____, swear (or affirm) that I am the _____ of _____, and that I have, in the foregoing report, truly and accurately reported the amount of the capital stock, the amount of the surplus, the undivided profits or undivided accumulations of said _____, and how or in what said surplus, undivided profits or undivided accumulations is invested."

§ 3. If any such bank, institution or corporation, on the first day of July in any year, has invested in the bonds or funds of the United States, which are by law exempt from taxation, more of its surplus, undivided profits or undivided accumulations than an amount equal to ten per cent. of such capital stock, the excess of the amount so invested over the amount equal to ten per cent. of such capital stock shall be exempt from taxation for that year and deducted from the amount of such surplus, undivided profits or undivided accumulations, upon which tax is to be assessed under this article, provided such was made in good faith and not for the purpose of avoiding taxation. The officer who makes the report required by the second section of this article shall attach to the report his affidavit, stating that such investment was made in good faith, and not for the purpose of avoiding

The Hewitt Act subjected banks accepting its provisions to two state taxes. First, the annual state levy on the value of each accepting bank's capital stock was raised to \$0.75 per \$100.⁷⁸ Further, the Hewitt Act imposed an annual state levy at the same rate as that assessed on real property on the portion of each accepting bank's surplus, undivided profit, and accumulations in excess of ten percent of its capital stock. To the extent the bank invested in exempt U.S. bonds or other obligations the value of which exceeded ten percent of the bank's capital stock, that

taxation.

§ 4. That each of said banks, institutions and corporations, by its proper corporate authority, with the consent of a majority in interest of a quorum of its stockholders, at a regular or called meeting thereof, may give its consent to the levying of said tax, and agree to pay the same as herein provided, and to waive and release all right under the act of Congress or under the charters of the State banks to a different mode or smaller rate of taxation, which consent or agreement to and with the State of Kentucky shall be evidenced by writing under the seal of such bank and delivered to the Governor of this Commonwealth; and upon such agreement and consent being delivered, and in consideration thereof, such bank and its shares of stock shall be exempt from all other taxation whatsoever so long as said tax shall be paid during the corporate existence of such bank.

§ 5. The said banks may take the proceeding authorized by section 4 of this act at any time until the meeting of the next General Assembly: *Provided*, They pay the tax provided for in section 1 from the passage of this act.

§ 6. This act shall be subject to the provisions of section eight (8), chapter sixty-eight (68), of the General Statutes.

§ 7. If any bank, State or National, shall refuse or fail to pay the tax imposed by this act, or shall fail or refuse to make the consent and agreement as prescribed in section 4, the shares of stock of such bank, institution or corporation and its surplus, undivided accumulations and undivided profits, shall be assessed as directed by section 2 of this act, and the same taxes, State, county and municipal, shall be imposed, levied and collected upon the assessed shares, surplus, undivided profits, undivided accumulations, as is imposed on the assessed taxable property in the hands of individuals: *Provided*, That nothing herein contained shall be construed as exempting from taxation for county or municipal purposes any real estate or building owned and used by said banks or corporations for conducting their business, but the same may be taxed for county and municipal purposes as other real estate is taxed.

Id.

⁷⁸ *Commonwealth v. Farmers' Bank*, 31 S.W. 1013, 1024 (Ky. 1895) (Paynter, J., dissenting) [hereinafter *Bank Tax Cases*].

additional amount was to be deducted from the otherwise taxable surplus.⁷⁹ Accepting banks who remitted these state taxes would be exempt from all local taxes, save their real estate alone, which would be taxed for county and municipal purposes as other real estate was taxed.⁸⁰

The Hewitt Act was a legislative offer. Banks, with the consent of a majority in interest of a quorum of their stockholders, could accept its provisions.⁸¹ Such consent would include consent to the levy and payment of the taxes as specified in the Act.⁸² Further, accepting banks were required to waive and release all rights under federal law (for national banks) or their charters (for state banks), to a different mode or a lesser rate of taxation. Such acceptance, waiver, and consent were to be accomplished in writing delivered to the governor.⁸³ The Hewitt Act constituted a bold attempt to level voluntarily the playing field for all financial institutions, applying not just to banks, but to "other institutions of loan and discount, and in all corporations required by law to be taxed on their capital stock."⁸⁴

The General Assembly unequivocally reclaimed its taxing authority over chartered banks by including in the Hewitt Act a direct reference to the Act of 1856. Specifically, the General Assembly made the Hewitt Act subject to the earlier enactment and legislatively deemed acceptance of the Hewitt Act to be acceptance of the Act of 1856.⁸⁵

Despite increasing the tax rates applicable to state banks chartered prior to 1856, the Hewitt Act proved to be a great success, with all banks operating in Kentucky accepting its provisions.⁸⁶ Certainly it was in the interest of the national banks and the state banks chartered subsequent to

⁷⁹ Hewitt Act, *supra* note 72, § 1.

⁸⁰ See also *Louisville Trust Co. v. City of Louisville*, 30 S.W. 991 (Ky. 1895).

⁸¹ Hewitt Act, *supra* note 72, § 4.

⁸² *Id.*

⁸³ *Id.*

⁸⁴ *Louisville Trust Co.*, 30 S.W. at 992. Trust companies, being treated as banks for tax purposes under their charters and taxed on their shares, could therefore likewise accept the provisions of the Hewitt Act. Unincorporated private banking institutions, however, were ultimately held not to be "other institutions of loan and discount" within the meaning of the Act. See also *City of Bowling Green v. Potter*, 14 S.W. 968 (1890); *City of Bowling Green v. Barclay, Potter & Co.*, 12 Ky. L. Rptr. 228 (1890).

⁸⁵ See Hewitt Act, *supra* note 72, § 6.

⁸⁶ See *Bank Tax Cases*, 31 S.W. 1013, 1024 (Ky. 1895) (Paynter, J., dissenting) (speculating that the banks realized they would be subject to the Act of 1856 when their charters were renewed). See also 1 LEWIS N. DEMBITZ, KENTUCKY JURISPRUDENCE 110 (1890).

1856 to accept the Hewitt Act because the banks thereby were released from the payment of county and municipal taxes. By agreeing to pay the specified state tax levy, they were released from the burden of local taxes, which in some parts of the state were two or three times greater than the specified state levy.⁸⁷ Post-1856 banks did not lose any rights by accepting the Hewitt Act because the state already had the right to change their method of taxation.

The more curious question is why three of the pre-1856 banks accepted the Hewitt Act and voluntarily subjected themselves to a higher tax burden.⁸⁸ The legislature had been renewing their charters. Perhaps these banks realized that an appeal would likely have been made to change their method of taxation if they were again renewed.⁸⁹ Alternatively, these banks

⁸⁷ See *Deposit Bank of Owensboro v. Daviess County*, 39 S.W. 1030, 1036 (Ky. 1897), *aff'd*, *Citizens' Sav. Bank of Owensboro v. City of Owensboro*, 173 U.S. 636, 650 (1899); *Bank Tax Cases*, 31 S.W. at 1024.

⁸⁸ The charters of the Bank of Kentucky, the Northern Bank and the Bank of Louisville were extended by the same Act of the General Assembly in 1858, and each of the charters was thereafter extended by subsequent legislative acts. In neither of the acts of extension is reference made to the Act of 1856, nor does either contain express limitation upon the taxing power of the state. Their charters clearly protected them from the application of the Act of 1856. However, it does not appear that the Farmers' Bank of Kentucky was so protected. The charter and amendments of the Farmers' Bank of Kentucky were extended by an Act of the General Assembly in 1876, but the right to repeal the charter and its amendments "either by general or special act" was reserved in the Act. Act of Mar. 10, 1876, 1875-76 Ky. Acts 634, at 324. The Act renewing Farmers' Bank of Kentucky's charter provided as follows:

That the charter of the Farmers' Bank of Kentucky, as amended, be extended for a period of twenty-five years from the termination of its charter as therein fixed: *Provided*, That said charter and amendments shall be subject to amendment or repeal by the general assembly, either by general or special act: *And provided further*, That whilst the privileges and franchises so granted may be changed or repealed, no amendment or repeal shall impair other rights previously vested.

Id. § 1. The Bank of Kentucky's shareholders ultimately agreed to accept the Hewitt Act by a unanimous vote. DUKE, *supra* note 7, at 126.

⁸⁹ The former Kentucky Court of Appeals, in *Franklin County Court v. Deposit Bank of Frankfort*, 9 S.W. 212, 216 (Ky. 1888), held that the Act of 1856 did not apply to subsequent acts extending charters granted before its passage because, by its third section, its application was limited "to charters and acts of incorporations to be granted" thereafter, and that the exemption from further taxation was as inviolable under the extended charter as it was during the life of the original charter. The court overruled *Franklin County Court* nine years later. *Deposit Bank*

may have realized that the Act of 1856 should have, by a proper interpretation, been made applicable to the Acts renewing their charters. In fact, one federal circuit court opined that the old banks:

had in fact no irrevocable exemption to surrender; and though they claimed it . . . it was so doubtful that they preferred to accept a somewhat higher rate of taxation by the state alone than to run the risk of being subjected to the much heavier taxation, both state and local, imposed by the seventh section of the Hewitt act upon banks which should not accept the proposal of the fourth section.⁹⁰

This attempt to resolve the tax controversies in the banking industry proved short-lived. Just five years later, Kentucky completely revised its standard local tax system, fomenting the most litigious period in the history of Kentucky's taxation of the banking industry.

Kentucky substantially revised the basic foundations of its state and local tax systems when it adopted its fifth and current constitution in 1891. Unlike the prior constitutions, the state's fifth organizational document contained a number of provisions governing state and local taxation. The 1891 Constitution established a fixed rule of taxation and made all property subject to taxation, whether for state or municipal purposes. In adopting the ad valorem system, the framers left no room for classifying property so as to make any discrimination in what was subject to taxation.⁹¹

The 1891 Constitution provided the General Assembly with little flexibility in matters of taxation, particularly ad valorem taxation. Sections 171, 172, and 174 of the 1891 Constitution mandate that all property not exempted therein must be taxed uniformly at its fair cash value.⁹² Section 175 further provides that "[t]he power to tax property shall not be surrendered or suspended by any contract or grant to which the Commonwealth shall be a party."⁹³ The former Kentucky Court of Appeals recognized in the *Bank Tax Cases* that

[i]t is manifest, by reason of section 175, the right of the legislature no longer exists of surrendering the power to tax property, or by contract to bind the state to any other mode of taxation than that found in the

of *Owensboro*, 39 S.W. at 1030.

⁹⁰ *N. Bank of Ky. v. Stone*, 88 F. 413, 425 (C.C.D. Ky. 1898).

⁹¹ KY. CONST.

⁹² *Id.* §§ 171, 172, 174.

⁹³ *Id.* § 175.

constitution; and all property, whether belonging to corporations or individuals, must pay the same rate of taxation.⁹⁴

The new constitution also proscribed the power of the General Assembly to issue individual charters, prohibiting their issuance altogether. To avoid Contract Clause issues with existing chartered entities, section 190 of the constitution required then-existing corporations to formally accept the provisions of the new constitution in order to "have the benefit of future legislation."⁹⁵ Such acceptance constituted a surrender of a corporation's special privileges and immunities granted under any prior special act of the legislature.⁹⁶

E. 1892: Amendment/Repeal of Charters and Attempted Taxation of Franchises

Upon adoption of the new constitution, the General Assembly met to enact implementing statutes. The session, which convened in late 1892 and early 1893, adopted a complete body of law governing the organization of corporations and, in addition, state banking institutions.⁹⁷

New revenue provisions were also enacted. Section 573 of the Kentucky Statutes, part of the general law on the subject of corporations (including banks) applied to and governed all corporations previously organized. Specifically intended to do away with special charter provisions, this new statute expressly repealed all privileges or immunities inconsistent with the provisions of the general law relating to corporations or which could not be obtained under the general law.⁹⁸

⁹⁴ *Bank Tax Cases*, 31 S.W. 1013, 1013-14 (Ky. 1895).

⁹⁵ KY. CONST. § 190.

⁹⁶ *Id.* § 3. See also *Vanceburg & Stout's Lane Tpk. Rd. Co. v. Chesapeake & Ohio Ry.*, 280 F. 482 (6th Cir. 1922).

⁹⁷ Act of Apr. 5, 1893, 1892-93 Ky. Acts 171, at 612 (codified as former KY. STAT. [hereinafter K.S.] §§ 539-76 (Barbour-Carroll 1894) (corporations) and *id.* §§ 577-98 (banks and banking)).

⁹⁸ See *Bruner v. Citizens' Bank of Shelbyville*, 120 S.W. 345, 346 (Ky. 1909). K.S. § 573 provided as follows:

The provisions of all charters and articles of incorporation, whether granted by special act of the General Assembly or obtained under any general incorporation law, which are inconsistent with the provisions of this chapter concerning similar corporations, to the extent of such conflict, and all powers, privileges or immunities of any such corporation which could not be obtained under the provisions of this chapter, shall stand repealed on

This repeal was consistent with corporations accepting the new Constitution.⁹⁹

The General Assembly of 1892-1893 also adopted a complete system of revenue laws which included an entirely new form of taxation on certain classes of corporations, including banks. The new tax regime for banks created by the Act of November 11, 1892 ("Revenue Act of 1892") was intended to repeal, and in express terms did repeal, the Hewitt Act.¹⁰⁰ In lieu of the Hewitt Act, the new revenue law provided for a system of taxation much more onerous than the one it replaced.¹⁰¹

The Revenue Act of 1892 imposed the first property tax on corporate franchises. Every incorporated bank "[a]nd every other like company, corporation or association"¹⁰² in addition to other taxes imposed by law were required annually to pay a tax on the fair cash value of its franchise to the state, and a local tax thereon to the county, incorporated city, town, or taxing district where its franchise might be exercised.¹⁰³

September 38, 1897; and if the officers, managers or agents of such corporation shall, after said date, exercise any powers, privileges or immunities repealed by this section or inconsistent with the provisions of this chapter, relating to similar corporations, or which could not be obtained under this chapter, the officer, manager or agent so offending, and the corporation for which he acts, shall each be guilty of a misdemeanor, and fined for each offense not less than one hundred nor more than one thousand dollars, and upon the conviction of the corporation, the trial jury may, at their discretion, direct the forfeiture of its charter or articles of incorporation, in which case the court shall so adjudge. After the twenty-eight day of September, 1897, the provisions of this chapter shall apply to all corporations created or organized under the laws of this State, if said provisions would be applicable to them if organized under this chapter.

⁹⁹ KY. CONST. § 190.

¹⁰⁰ Act of Nov. 11, 1892, 1891-1893 Ky. Acts 103, at 277.

¹⁰¹ See *id.* Art. III, §§ 1-2 (originally codified at K.S. §§ 4077-92) (currently codified as amended at K.R.S. §§ 136.115 - 136.180 (Michie 2001)); see also *Stone v. Bank of Commerce*, 174 U.S. 412, 414 (1899).

¹⁰² *Providence Banking Co. v. Webster County*, 57 S.W. 14, 15 (Ky. 1900) (holding that this language subjected unincorporated, private banks to state and local franchise taxes).

¹⁰³ Act of Nov. 11, 1892, 1891-1893 Ky. Acts 103, Art. III, § 1. This new franchise tax was originally codified at K.S. § 4077, the precursor to K.R.S. § 136.120, which currently levies a franchise tax on public service companies. Banks are no longer subject to the tax. The tax imposed by the Revenue Act of 1892 was technically styled a "franchise tax." However, both the U.S. Supreme Court and the former Kentucky Court of Appeals held the tax to be in fact an ad valorem property tax—the legislative intent was that the entire property, tangible and intangible, of

A state Board of Valuation and Assessment composed of the State Auditor, Treasurer, and Secretary of State, established the fair cash value of each corporation's franchise for tax purposes and apportioned that value among the several taxing jurisdictions entitled to levy a tax on the franchise. Each corporation reported to the Auditor the amount of capital stock, stock paid up, par and real value, highest price at which it had sold in the twelve months preceding September 15, amount of surplus and undivided profits and value of other assets, total indebtedness, amount of gross or net earnings or income, and amount of tangible property liable for tax.¹⁰⁴ From the gross and net income, the Board fixed the value of the capital stock. From the value of the capital stock, the assessed value of all tangible property was deducted and the remainder was the value of the corporate franchise subject to tax. The Auditor then notified the taxpayer of the taxable value, which determination could be protested within thirty days.¹⁰⁵ At the end of thirty days, the Auditor certified to the county clerk the value of the franchise for purposes of levying and collecting local taxes.¹⁰⁶

The Kentucky courts construed this new "franchise tax" to be a property tax, though nominally levied on the taxpayer's corporate franchise.¹⁰⁷ Shares in banks (and other corporations subject to the franchise tax) were exempt from ad valorem taxation provided the corporation paid all taxes on corporate property and its franchise.¹⁰⁸ Shares

all foreign and domestic corporations, and all foreign and domestic companies, possessing no franchise, should be valued as an entirety, that the value of the tangible property should be deducted, and that the value of the intangible property thus ascertained should be taxed under this new provision. *See Adams Exp. Co. v. Kentucky*, 166 U.S. 171 (1897); *Henderson Bridge Co. v. Commonwealth*, 31 S.W. 486 (Ky. 1895), *aff'd*, 166 U.S. 150 (1897); *see also Louisville Tobacco Warehouse Co. v. Commonwealth*, 49 S.W. 1069 (Ky. 1899); *Louisville Ry. Co. v. Commonwealth*, 49 S.W. 486 (Ky. 1899); *Commonwealth v. Louisville Water Co.*, 37 S.W. 576 (Ky. 1896), *rev'd*, 170 U.S. 127 (1898).

¹⁰⁴ K.S. § 4078 (Carroll 1903).

¹⁰⁵ *Id.* § 4083.

¹⁰⁶ *Id.* § 4084. The Act of March 19, 1898 established a separate reporting and valuation method for corporate franchises by cities of the first and second class. Act of Mar. 19, 1898, 1898 Ky. Acts 38, at 76 (codified at K.S. §§ 2984a-1 through 13).

¹⁰⁷ *See Henderson Bridge Co.*, 31 S.W. at 486; *see also Louisville Ry.*, 49 S.W. at 486; *Louisville Tobacco Warehouse Co.*, 49 S.W. at 1069; *Louisville Water Co.*, 37 S.W. at 576.

¹⁰⁸ K.S. §§ 4085, 4088; *see also Commonwealth v. Steele*, 104 S.W. 687, 688 (Ky. 1907). The Revenue Act of 1892 enacted Kentucky's first comprehensive tax on intangible personal property being taxed at a uniform rate of \$0.425 per \$100

of stock in corporations operating outside the state remained taxable to resident shareholders. Just six years earlier, the banks had voluntarily accepted the terms of the Hewitt Act. For the banks, particularly the three pre-1856 banks, the Revenue Act of 1892 must have been seen as a legislative "bait and switch." The banks, baited by the legislative promise of a low tax rate, had in good faith voluntarily relinquished any charter rights they still enjoyed.

IV. 1892-1899: BANK WARS—

CHARTER RIGHTS, DISCRIMINATION AND THE CONTRACT CLAUSE

The levy in 1892 of state and local franchise taxes, in conjunction with the attempted repeal of the Hewitt Act, generated a great deal of litigation. State and national banks challenged the new franchise tax almost immediately. Those challenges resulted in one of the most unusual situations in Kentucky tax history.

A. *Contract Clause Challenges*

In 1895, seventeen actions brought by a number of state and national banks reached the former Kentucky Court of Appeals. The actions challenged the attempted levy of local franchise taxes by a number of cities and counties under the Revenue Act of 1892. The banks claimed the levies were contrary to the banks' rights under the contract created by their acceptance of the provisions of the Hewitt Act.¹⁰⁹ The court consolidated

of value. See Rick Alsip et al., Note, *St. Ledger v. Kentucky Revenue Cabinet: The Tax That Would Not Die*, 86 KY. L.J. 1053, 1053-57 (1998). This exemption from tax of shares in corporations paying Kentucky property tax was ultimately determined to be unconstitutional as violating the Commerce Clause one hundred and five years later. *St. Ledger v. Kentucky Revenue Cabinet*, 942 S.W.2d 893 (Ky. 1997).

¹⁰⁹ The litigation involving the city of Louisville's bank franchise tax was particularly interesting. Louisville levied a bank franchise tax in 1894, equal to four percent of gross receipts, which was challenged in a very organized manner. Nearly all banks which had accepted the Hewitt Act and were subject to the city's franchise tax entered into an agreement with the city governing how the city's tax was to be challenged. The agreement divided the banks into three categories; (1) banks whose state charters had been granted on or before February 14, 1856, (2) banks whose state charters had been granted subsequent to February 14, 1856, and (3) national banks. The Bank of Kentucky, Louisville Banking Company, and Third National Bank, respectively, were chosen as representatives for each class of banks to file actions challenging the city's levy on behalf of their respective classes. The

these cases and, in the *Bank Tax Cases*,¹¹⁰ held that the provisions of the Hewitt Act, when accepted by the bank seeking to avail itself of its privileges, constituted a valid and binding contract protected under the Contract Clause.¹¹¹ This statutory contract excused the banks from the payment of any tax except the \$0.75 per \$100 of share value established under the Hewitt Act. Of particular importance, the court's decree was not limited to the particular years of assessment in question, but adjudicated the broader right of the banks to be protected under the U.S. Constitution against state enactments in violation of the provisions of the Hewitt Act. Under procedural rules at the time, the decision could not be appealed to the U.S. Supreme Court.¹¹²

At the time the *Bank Tax Cases* was decided, there were seven other actions then pending that had been brought by a number of other state

representative banks agreed to loan the city four percent of their gross receipts for the year 1893 at four percent interest, to make no franchise tax payment, and thereby have standing to immediately file actions challenging the city's tax. The remaining banks, as an unconditional payment, agreed to pay the city the difference between the amount of *state* taxes they paid under the Hewitt Act and the lower amount of *state* taxes required under the Revenue Act of 1892 while the litigation proceeded. Further, the remaining banks agreed to loan to the city the difference between the amount otherwise due under the city's franchise tax and the unconditional amount each year at four percent interest. If the banks were unsuccessful, the city was to retain the amounts loaned as full payment for the franchise taxes owed. If successful, the city was to repay the amounts with the interest then accrued. *Stone v. Bank of Commerce*, 174 U.S. 412, 414-18 (1899).

¹¹⁰ *Bank Tax Cases*, 31 S.W. 1013 (Ky. 1895). The seventeen actions consolidated on this appeal were titled as following: (1) Commonwealth v. Farmer's Bank of Ky.; (2) Farmer's Bank of Ky. v. Bd. of Councilmen; (3) Farmer's Bank of Ky. v. Franklin County; (4) Bank of Ky. v. Armstrong; (5) Bank of Ky. v. Bd. of Councilmen; (6) Commonwealth v. Bank of Ky.; (7) Commonwealth v. Deposit Bank of Frankfort; (8) Deposit Bank of Frankfort v. Franklin County; (9) Commonwealth v. Frankfort Nat'l Bank; (10) Commonwealth v. State Nat'l Bank; (11) Third Nat'l Bank v. City of Louisville; (12) Louisville Banking Co. v. City of Louisville; (13) City of Louisville v. Bank of Ky.; (14) N. Bank of Ky. v. Bourbon County; (15) City of Covington v. First Nat'l Bank of Covington; (16) City of Covington v. German Nat'l Bank of Covington; and (17) Farmers' Bank of Ky. v. City of Henderson.

¹¹¹ See also *Citizens' Bank of Shelbyville v. City of Shelbyville*, 39 S.W. 1116 (Ky. 1897).

¹¹² Appeal was not available because the former Kentucky Court of Appeals found the actions of the local taxing authorities invalid. At the time, review was available only if the court had found the actions lawful. See 16B CHARLES ALAN WRIGHT ET AL., *FEDERAL PRACTICE AND PROCEDURE* § 4006 (2d ed. 1996).

banks challenging the validity of city and county franchise taxes. These cases also were consolidated on appeal and reached the former Kentucky Court of Appeals eighteen months later. By that time, however, the composition of the court had changed. The new court in *Deposit Bank of Owensboro v. Daviess County*,¹¹³ overturned the *Bank Tax Cases* and held that the Act of 1856 properly reserved the power of repeal and amendment to the General Assembly and, therefore, upheld the legislative revocation of contracts made under the Hewitt Act.¹¹⁴ The banks, by accepting the provisions of the Hewitt Act, had not acquired any contract rights with the state with reference to the mode or right of taxation. Thus, the franchise tax provisions of the Revenue Act of 1892 were constitutional, and shares of stock in banks were subject to county and municipal taxation. As to national banks, the court noted that it had been unnecessary for them to accept the Hewitt Act as they were already subject to taxation for state, county and municipal purposes. On appeal,¹¹⁵ the U.S. Supreme Court, in *Citizens' Savings Bank of Owensboro v. City of Owensboro*, affirmed the holding as to state banks.¹¹⁶ The Court's position as to the taxation of national banks was ultimately rebutted in *Owensboro National Bank v. City of Owensboro*.¹¹⁷

After *Deposit Bank of Owensboro v. Daviess County* and, on appeal, *Citizens' Savings Bank of Owensboro v. City of Owensboro*, it was the settled law that the Hewitt Act did not constitute an irrevocable contract between the state and the banks as to taxation, but was subject to modification and repeal by subsequent legislation undertaking to tax bank property. This, however, was not the end of the banks' attempt to avoid the Revenue Act of 1892.

B. *Res Judicata Challenges*

While litigation proceeded in the *Bank Tax Cases*, *Deposit Bank of Owensboro v. Daviess County* and *Citizens' Savings Bank of Owensboro v. City of Owensboro*, Kentucky localities had continued their efforts to levy and collect franchise taxes from the banks. Thus, additional actions

¹¹³ *Deposit Bank of Owensboro v. Daviess County*, 39 S.W. 1030 (Ky. 1897).

¹¹⁴ *Id.* at 1031.

¹¹⁵ Appeal from this subsequent decision was available because the Kentucky court upheld the actions by the local taxing authorities. See *supra* note 112.

¹¹⁶ *Citizens' Sav. Bank of Owensboro v. City of Owensboro*, 173 U.S. 636, 650 (1899).

¹¹⁷ *Owensboro Nat'l Bank v. City of Owensboro*, 173 U.S. 664 (1899).

were filed challenging local taxes assessed with respect to these subsequent periods. The banks that successfully participated in the *Bank Tax Cases* had binding judgments from the former Kentucky Court of Appeals prohibiting certain local taxing authorities from collecting local taxes. In a series of decisions, the federal courts held that, despite being overruled, the *Bank Tax Cases* estopped the defendant localities from seeking to collect taxes under the Revenue Act of 1892 from the plaintiff banks under principles of res judicata.¹¹⁸ The primary decision of the federal circuit court on this issue noted that a judgment in a suit for taxes could be held to be an estoppel against a state or any agency of the state for the collection of taxes in a suit for taxes subsequently accruing.¹¹⁹ The U.S. Supreme Court upheld this ruling.¹²⁰ At the conclusion of this litigation, defendant taxing districts

¹¹⁸ As to state banks, the federal courts held that the *Bank Tax Cases* precluded the subsequent levies under the Revenue Act of 1892 by the defendants therein for subsequent periods. *See Farmers' Bank of Ky. v. Stone*, 88 F. 987 (C.C.D. Ky. 1898), *aff'd*, 174 U.S. 409 (1899); *Louisville Banking Co. v. City of Louisville*, 88 F. 988 (C.C.D. Ky. 1898), *aff'd sub nom. Stone v. Bank of Ky.*, 174 U.S. 409 (1899); *Deposit Bank of Frankfort v. Stone*, 88 F. 986 (C.C.D. Ky. 1898); *Bank of Ky. v. City of Louisville*, 88 F. 985 (C.C.D. Ky. 1898), *aff'd sub nom. Stone*, 174 U.S. at 409; *N. Bank of Ky. v. Stone*, 88 F. 413 (C.C.D. Ky. 1898); *Bank of Ky. v. Stone*, 88 F. 383 (C.C.D. Ky. 1898), *aff'd sub nom. Stone*, 174 U.S. at 409. The same principles of res judicata applied to federal banks. *But see Third Nat'l Bank v. Stone*, 174 U.S. 432 (1899) (holding that same principles apply but res judicata is not applicable to periods after the termination or extension of the charter in existence during the period governed by the prior judgment).

¹¹⁹ *Stone*, 88 F. at 383 (citing *City of New Orleans v. Citizens' Bank of La.*, 167 U.S. 371 (1897)).

¹²⁰ *Third Nat'l Bank v. City of Louisville*, 88 F. 990 (C.C.D. Ky. 1898), *rev'd in part*, 174 U.S. 432 (1899), *aff'd in part*, 174 U.S. 435 (1899); *Louisville Banking Co.*, 88 F. at 988; *Farmers' Bank of Ky.*, 88 F. at 987; *Deposit Bank of Frankfort*, 88 F. at 986; *Bank of Ky.*, 88 F. at 985; *Bank of Ky. v. City of Louisville*, 88 F. 988 (C.C.D. Ky. 1898), *aff'd without opinion sub nom. Stone v. Bank of Ky.*, 174 U.S. 799 (1899); *N. Bank of Ky.*, 88 F. at 413; *Bank of Ky.*, 88 F. at 383; *but see City of Louisville v. Bank of Commerce*, 174 U.S. 428 (1899); *Stone v. Bank of Commerce*, 174 U.S. 412 (1899); *First Nat'l Bank of Covington v. City of Covington*, 129 F. 792 (C.C.D. Ky. 1903), *aff'd*, 198 U.S. 100 (1905); *Bd. of Councilmen v. Deposit Bank of Frankfort*, 57 S.W. 787 (Ky. 1900).

The res judicata cases yielded a strange result. Under Kentucky principles of res judicata, a judgment in a suit as to one year's taxes is not res judicata as to another year's taxes. *See Cave Hill Cemetery Co. v. Scent*, 352 S.W.2d 61, 64 (Ky. 1961); *Louisville Bridge Co. v. City of Louisville*, 65 S.W. 814 (Ky. 1901); *Bell County Coke & Improvement Co. v. City of Pineville*, 64 S.W. 525 (Ky. 1901); *Negley v. City of Henderson*, 59 S.W. 19 (Ky. 1900); *Louisville Bridge Co. v. City of Louisville*, 58 S.W. 598 (Ky. 1900); *City of Newport v. Commonwealth*, 51

in the *Bank Tax Cases* were not estopped from levying taxes against banks who were not plaintiffs in the action.¹²¹ The plaintiff banks, however, enjoyed an exemption from local taxation altogether. The net result was unequal taxation of state banks, some of which thereby enjoyed a substantial competitive advantage.

C. National Bank Challenges under Federal Law

In addition to challenging the Revenue Act of 1892 on Contract Clause grounds, national banks challenged the franchise tax as exceeding the limited ability to tax granted by Congress to the state. Reviewing the decision as to national banks in the *Bank Tax Cases*, the U.S. Supreme Court in *Owensboro National Bank v. City of Owensboro* held that the tax levied pursuant to the Revenue Act of 1892 was a tax levied upon the franchise or intangible property of national banks.¹²² Because states and localities were limited by federal statute to levying taxes on national bankshares and real property only, the Court held that the Kentucky General Assembly's enactment of a franchise tax on national banks exceeded the authority conferred by Congress and was therefore unlawful.¹²³

S.W. 433, supplemented by 51 S.W. 433 (Ky. 1899). However, the federal doctrine of res judicata mandates that a judgment in a suit for taxes constitutes an estoppel against a state or any agency of the state for the collection of taxes in a suit for taxes subsequently accruing. See *Citizens' Bank of La.*, 167 U.S. at 371. In *First National Bank of Covington v. City of Covington*, 129 F. at 792, it was held that a judgment by a Kentucky court as to one year's taxes was not res judicata as to another year's taxes regardless of whether the subsequent challenge was brought in a Kentucky or federal court. However, a judgment by a federal court as to one year's taxes was res judicata as to another year's taxes regardless of whether the subsequent challenge was brought in a Kentucky or federal court. See *Deposit Bank of Frankfort v. Bd. of Councilmen*, 191 U.S. 499 (1903).

¹²¹ The U.S. Supreme Court, in *Stone v. Bank of Commerce*, 174 U.S. at 412, held that the city of Louisville was not estopped or precluded by the *Bank Tax Cases* from assessing a franchise tax against the banks who were parties to the agreement with the city of Louisville governing the challenge to the city's franchise tax, but who were not the representative parties in the actions brought thereunder. See also *supra* note 109. Banks which were not parties in the *Bank Tax Cases* were subject to the Revenue Act of 1892 and could be retroactively assessed for local taxes if they had failed to pay such taxes while the litigation proceeded. *Bohannon v. Bank of Shelbyville*, 63 S.W. 474 (Ky. 1901).

¹²² *Owensboro Nat'l Bank*, 173 U.S. at 664.

¹²³ See also *First Nat'l Bank of Louisville v. City of Louisville*, 174 U.S. 438 (1899); *City of Louisville v. Citizens' Nat'l Bank*, 174 U.S. 436 (1899); *City of Louisville v. Third Nat'l Bank*, 174 U.S. 435 (1899); *Third Nat'l Bank v. Stone*, 174 U.S. 432 (1899).

Arguably national banks were taxable in Kentucky only on their real property. Kentucky at that time had no statute expressly taxing national bankshares. The broad tax on intangibles authorized by the Revenue Act of 1892 could capture these shares, but the shares were possibly exempted because these banks were paying Kentucky tax on all of their *taxable* property. Despite this lack of clear statutory authority, at least one enterprising sheriff nevertheless included in county citizens lists of property the shares held by them in national banks. The assessment of those shares and the levy of ad valorem tax thereon generated yet another legal challenge to the validity of such taxation. The former Kentucky Court of Appeals, in *Scobee v. Bean*,¹²⁴ held that if the bank itself was not taxable,

then our statutes, *by necessary implication*, require the stockholder to list his shares of stock for taxation. . . . But it is to be noticed that the general laws are merely declaratory of the requirements of the constitution (section 174), which declares that "all property, whether owned by natural persons or corporations, shall be taxed in proportion to its value, unless exempted"; and while the general provisions of our statutes were not intended, perhaps, to be the particular provisions under which bank stocks were in fact to be assessed, still the general provisions, constitutional and statutory, lie at the foundation of the authority to tax, and are sufficiently specific to authorize the taxation of every species of moneyed capital in the state.¹²⁵

The court summarily dismissed the argument that allowing national bankshares to be taxed in the hands of the shareholders while not taxing the shares of state banks constituted unlawful discrimination. Despite this clear victory, it appears that *Scobee* was a unique situation, and national bankshares went largely untaxed during the 1892 to 1900 taxable years.

The substantial litigation over the Revenue Act of 1892 created a harsh and unfair tax regime for banks. State banks that had obtained judgments prohibiting local jurisdictions from levying franchise taxes under the Contract Clause remained exempt from franchise taxation by those

¹²⁴ *Scobee v. Bean*, 59 S.W. 860 (Ky. 1900).

¹²⁵ *Id.* at 861 (emphasis added); see *Commonwealth v. Citizen's Nat'l Bank*, 80 S.W. 158 (Ky. 1904), *dismissed for want of jurisdiction*, 199 U.S. 603 (1905); see also *Standard Oil Co. v. Boone County Bd. of Supervisors*, 562 S.W.2d 83 (Ky. 1978) (same); *Bd. of Councilmen v. Capital Gas & Elec. Light Co.*, 96 S.W. 870 (Ky. 1906) (species of property exempted by statute but not by the Constitution are taxable).

localities under principles of *res judicata*. Because the state was not a party to these actions, these banks remained subject to the state franchise tax. All other state banks were subject to both state and local franchise taxes. National banks were completely exempt from state and local franchise taxation by operation of federal statute. Their shares were taxable in the hands of their shareholders but generally went untaxed.

V. 1900-1905: THE GENERAL ASSEMBLY STRIKES BACK

The national banks' successful challenge to state and local franchise taxes left those state banks unprotected by *res judicata* at a considerable disadvantage; the Revenue Act of 1892 had substantially increased their tax burden.¹²⁶ Recognizing the inequality and the lack of uniformity in the assessment and payment of taxes resulting from the various decisions of the courts, the General Assembly, while the *Scobee v. Bean* action was pending, sought to correct the problem during its 1900 Regular Session.

A. State Banks: Conform or Dissolve

With respect to state banks, the General Assembly concluded that parties to the *Bank Tax Cases* should not be entitled to continue to do business while paying only limited taxes under the Hewitt Act. Competitor state banks subject to the Revenue Act of 1892 were severely disadvantaged, if not precluded altogether, from fairly competing. The General Assembly, under the Act of 1856, had the right to repeal the charters of those banks, but did not have the right, while they continued to do business under existing charters, to change their method of taxation. In light of the decisions of the courts and in order to correct the manifest injustice that had resulted, the General Assembly passed the Act of March 22, 1900, repealing the charters of the state banks which had received favorable *res judicata* rulings.¹²⁷ These banks could obtain a reprieve from this statutory

¹²⁶ See *Bank Tax Cases*, 31 S.W. 1013 (Ky. 1895).

¹²⁷ Act of Mar. 22, 1900, 1900 Ky. Acts 28, at 88. This Act provided as follows:

Whereas, By virtue of a recent decision of the Supreme Court of the United States, all banks of this State, both State and national, are now required to pay State and local taxes in Kentucky, except the Bank of Kentucky, the Farmers Bank of Kentucky and the Deposit Bank of Frankfort, which three last named banks, by virtue of said decision, are now claiming exemption from all State and local taxes, except as provided in the Hewitt Law, during their corporate existence; therefore,

death penalty only by consenting to local franchise taxation beginning in 1900 and for subsequent years.¹²⁸

This carrot and stick approach generally proved successful. At least one state bank, the Bank of Kentucky, reorganized as a national bank to avoid paying local franchise taxes.¹²⁹ It appears that the other state banks consented to the new tax regime.

B. National Banks: Retroactive Taxation

The U.S. Supreme Court held in *Owensboro National Bank* that the franchise tax enacted to replace the Hewitt Act was void as to national banks.¹³⁰ Therefore, federal banks paid taxes only on their real property; there was no state statute levying a tax on the shares of national banks for local purposes until 1900. In its search for equality of taxation in the banking industry, the General Assembly resolved to deal harshly with national banks, which had basically enjoyed business privileges in the state free of all bank taxes since 1892. Its ultimate resolution was to retroactively equalize the tax burden. The Act of March 21, 1900 ("Act of 1900")

Be it enacted by the General Assembly of the commonwealth of Kentucky:

§ 1. That an act, entitled "An act to establish the Bank of Kentucky," approved February sixteenth, eighteen hundred and thirty-four, and all amendments and extensions thereof, also an act entitled "An act to incorporate the Farmers Bank of Kentucky," approved February sixteenth, eighteen hundred and fifty, and all amendments and extensions thereof, also an act entitled "An act to incorporate the Deposit Bank of Frankfort," approved March third, eighteen hundred and sixty-three, and all amendments and extensions thereof, be, and the same *are hereby, repealed. Provided*, That if said banks or either of them, on or before May first, nineteen hundred, file in Secretary of State's office their or its written consent to pay taxes under State and local levies of nineteen hundred and subsequent years, as provided in the Constitution and revenue statutes of this State, the bank or banks thus agreeing shall be excepted from the operation of this act.

Id. § 1 (emphasis added).

¹²⁸ *Id.*

¹²⁹ See *Hager v. Citizens' Nat'l Bank of Lebanon*, 105 S.W. 914, 915 (Ky. 1907) (Barker, J., dissenting) (Bank of Kentucky reorganized as the National Bank of Kentucky); *Bank of Ky. v. Commonwealth*, 94 S.W. 620, 621 (Ky. 1906) (National Bank of Kentucky organized on May 1, 1900 and Bank of Kentucky's assets transferred thereto).

¹³⁰ *Owensboro Nat'l Bank v. Owensboro*, 173 U.S. 664 (1899).

provided for the prospective and retroactive state and local taxation of national banks upon their shares, levying a tax on shares that had escaped taxation for the prior eight years.¹³¹ The stated purpose of this Act was to

¹³¹ Act of Mar. 21, 1900, 1900 Ky. Acts 23, at 65. The Act provided as follows:

Whereas, The Supreme Court of the United States has lately decided that article three (3), chapter one hundred and three (103) of the acts eighteen hundred and ninety-one, eighteen hundred and ninety-two, eighteen hundred and ninety-three is void and of no effect in so far as the same provides for the taxation of the franchise of national banks, in consequent of which decision there is not now and has not been since adoption of said article in eighteen hundred and ninety-two, any adequate mode of taxing national banks, while State banks are now, and have been ever since eighteen hundred and ninety-two, taxable for all purposes, State and local; therefore,

Be it enacted by the General Assembly of the Commonwealth of Kentucky:

§ 1 That the shares of stock in each national bank of this State shall be subject to taxation for all State purposes, and shall be subject to taxation for the purposes of each county, city, town and taxing district in which the bank is located.

§ 2 For purposes of the taxation provided for by the next preceding section, it shall be the duty of the president and the cashier of the bank to list the said shares of stock with the assessing officers authorized to assess real estate for taxation, and the bank shall be and remain liable to the State, county, city, town and district for the taxes upon said shares of stock.

§ 3 When any of said shares of stock have not been listed for taxation for any of said purposes under levy or levies of any year or years since the adoption of the revenue law of eighteen hundred and ninety-two, it shall be the duty of the president and cashier to list the same for taxation under said levy or levies: Provided, That where any national bank has heretofore, for any year or years, paid taxes upon its franchise as provided in article three (3) of the revenue law of eighteen hundred and ninety-two, said bank shall be excepted from the operation of this section as to said year or years: And provided further, That where any national bank has heretofore, for any year or years, paid State taxes under the Hewitt bill in excess of the State taxes required by this act for the same year or years, said bank shall be entitled to credit by said excess upon its state taxes required by this act.

§ 4 All assessments of shares of stock contemplated by this act shall be entered upon the assessor's books, certified and reported by the assessing officers as assessments of real estate are entered, certified and reported, and the same shall be certified to the proper collecting officers for collection as assessments of real estate are certified for collection of taxes thereon.

§ 5 The assessments of said shares of stock and collection of taxes thereon, as contemplated by this act, may be enforced as assessments of real

make the taxes on national banks and state banks as nearly equal as possible. Those national banks that had complied with the Revenue Act of 1892 were excepted from the retroactive operation of the new bankshares tax. Others that had paid taxes under the Hewitt Act were given credit for the amount paid. Further, unlike the scheme authorized in *Scobee*, the Act required the president and cashier of each national bank whose shares had not been taxed to list the shares and pay the applicable taxes as agent for and on behalf of its shareholders.¹³² By separate act, the General Assembly authorized cities of the first, second and third classes to levy taxes on shares of state banks as well as those of national banks.¹³³

estate and collection of taxes thereon may be enforced.

§ 6 The purpose of this act is to place national banks of this State, with respect to taxation, upon the same footing as State banks as nearly as may be consistently with said article three (3) of the revenue law and said decision of the Supreme Court.

§ 7 Whereas, it is important that State banks and national banks should be taxed equally for all purposes, an emergency exists, and this act shall take effect and be in force from and after its passage.

Id. §§ 1-7.

¹³² This attempt to retroactively level the playing field proved only partially successful. The U.S. Supreme Court in *Covington v. First National Bank of Covington*, 198 U.S. 100 (1905), held this feature of the Act of 1900, so far as it retroactively applied to nonresident stockholders, invalid. *But see* *Citizens Nat'l Bank v. Kentucky*, 217 U.S. 443 (1910) (Act of 1900 valid as to resident stockholders). The real value of the credit provision is unknown; it is questionable how successful the national banks were in determining which of their shareholders had paid property taxes on their shares, to which taxing districts, and in which years during the prior eight year period of retroactivity.

¹³³ Act of Mar. 22, 1900, 1900 Ky. Acts 29, at 89. The effect of this change is unclear. Under the Act of 1900, all cities were authorized to levy taxes on franchises of state banks and trust companies. The subsequent Act of March 22, 1900, 1900 Ky. Acts 29, thus appears to be inconsistent and either authorized such cities to levy both shares and franchise taxes, only shares taxes or shares taxes only if a bank or trust company failed to pay a local franchise tax. By Act of March 18, 1904, 1904 Ky. Acts 33, § 3, this provision was changed yet again, limiting its application to cities of the first class only. This provision was considered repealed as to all but cities of the first class by the Act of March 15, 1906, 1906 Ky. Acts 22, Art. IV, subd. 2, § 4, and is now codified at K.R.S. §§ 91.620 to 91.670 (Michie 1982). Nevertheless, the General Assembly in exempting most intangible personal property from local ad valorem taxation specifically provided "that nothing . . . shall forbid local taxation of franchises of corporations or of the shares of banks, trust companies, or combined banks and trust companies doing business in Kentucky" and provided a reporting and valuation mechanism with respect to

Based upon the federal res judicata decisions, it appeared that banks that had obtained favorable Contract Clause decisions against localities with respect to taxes under the Revenue Act of 1892 could continue to rely on those judgments to preclude those defendant localities from assessing local bankshares taxes under the new regime of 1900. One such national bank acted on this assumption and sought to enjoin the city of Covington from assessing local tax on its shares. In *Covington v. First National Bank of Covington*,¹³⁴ the U.S. Supreme Court added a fresh strand to the complicated web created by the *Bank Tax Cases* and the subsequent res judicata decisions.¹³⁵

The U.S. Supreme Court, in *First National Bank of Covington* effectively reversed its decision in *Stone v. Bank of Kentucky*¹³⁶ based on a deeper analysis of res judicata. The Court recognized that under Kentucky principles of res judicata, a judgment in a suit as to one year's taxes is not res judicata as to another year's taxes.¹³⁷ However, the federal doctrine of res judicata mandates that a judgment in a suit for taxes precludes the taxing authority from collecting taxes subsequently accruing.¹³⁸ Applying these principles to the Contract Clause litigation, the Court held that a judgment of a federal court that the Hewitt Act created an irrevocable contract estopped or precluded the defendant taxing authority from levying taxes on the plaintiff bank contrary to the contract for subsequent years. This was true whether subsequently pled as res judicata in federal or state court.¹³⁹ The opposite result obtained with respect to Kentucky judgments. A judgment by a Kentucky court prohibiting the levy of taxes on contract grounds did not preclude the levy of taxes in a subsequent year, regardless of whether res judicata was pled in a Kentucky or federal court. Because

shares in banks and trust companies. Act of May 2, 1917 Ky. Acts (Ex. Sess.) 11, § 4 (originally codified at K.S. § 4019a-10 (Baldwin 1922), and later codified as amended at K.R.S. § 132.200).

¹³⁴ *First Nat'l Bank of Covington*, 198 U.S. at 100.

¹³⁵ The First National Bank of Covington had successfully challenged the city of Covington's levy of franchise taxes in the *Bank Tax Cases*.

¹³⁶ *Stone v. Bank of Ky.*, 174 U.S. 799 (1899).

¹³⁷ See *Louisville Bridge Co. v. City of Louisville*, 65 S.W. 814 (Ky. 1901); *Bell County Coke & Improvement Co. v. City of Pineville*, 64 S.W. 525 (Ky. 1901); *Negley v. City of Henderson*, 59 S.W. 19 (Ky. 1900); *Louisville Bridge Co. v. City of Louisville*, 58 S.W. 598 (Ky. 1900); *City of Newport v. Commonwealth*, 50 S.W. 845, supplemented by 51 S.W. 433 (Ky. 1899).

¹³⁸ See *New Orleans v. Citizens' Bank*, 167 U.S. 371 (1897).

¹³⁹ See *Deposit Bank of Frankfort v. Bd. of Councilmen of Frankfort*, 191 U.S. 499 (1903) (federal judgment was res judicata in a subsequent state action).

the plaintiff national bank had obtained a judgment against the city of Covington from the former Kentucky Court of Appeals, the city was not precluded from levying taxes under the Act of 1900.¹⁴⁰ The *First National Bank of Covington* decision effectively invalidated prior holdings which had held that the *Bank Tax Cases* precluded subsequent local taxation on res judicata principles.¹⁴¹ This decision was five years too late to assist Kentucky in equalizing its bank taxing system.

Despite the judicial validation of these changes, the General Assembly remained dissatisfied. The legislature adopted a general revision of the revenue law just two years later in the Act of March 29, 1902 ("Act of 1902"),¹⁴² codifying the results of the litigation over the 1892 and 1900 Revenue Acts. As revised, the statutes provided that state banks were taxable on their assets through state and local franchise taxes (unless barred by res judicata) and national banks were subject to state and local taxes on their shares.¹⁴³

The Act of 1902 codified not only different tax regimes for state and national banks but also different regimes for valuation. Franchises of state banks were assessed by the State Board of Valuation and Assessment. National bankshares, however, were assessed by the local assessors.¹⁴⁴

¹⁴⁰ The city of Covington had also retroactively assessed the bank for taxes on its shares for the period between 1893 to 1900. The Court noted that under *Scobee*, taxes on shares in national banks were collectible directly from shareholders resident in Kentucky during that period. However, the Court also pointed out that nonresident shareholders were not subject to such taxes because they were not within Kentucky taxing jurisdiction. Because the Act of 1900 appeared to authorize taxes on the bank with respect to shares held by nonresident shareholders, the Act appeared to levy a tax on national banks not borne by other moneyed capital in Kentucky in contravention of federal statute. On this ground, the Court upheld the decision of the lower court enjoining the city from levying shares taxes during this period. *Covington v. First Nat'l Bank of Covington*, 198 U.S. 100 (1905).

¹⁴¹ This conclusion assumes that the courts would not find that the res judicata decisions of the federal courts subsequently obtained by many of the plaintiffs in the *Bank Tax Cases* would not, themselves, preclude the local taxing authorities from levying taxes under federal res judicata principles. No court ruled on this issue.

¹⁴² Act of Mar. 29, 1902, 1902 Ky. Acts. 128, subd. II.

¹⁴³ National bankshares were subject to local taxation by the local taxing districts in which the bank was located.

¹⁴⁴ A national bank's shares were assessed by the local assessor where the bank was located. It is unclear whether cities of the first and second class continued to value and assess franchises of state banks and national bankshares separately. See *supra* note 105.

The General Assembly once again tweaked the system in 1904 in an effort to bring uniformity to the assessment regime. The 1904 changes required both the franchises of state banks and the shares of national banks doing business in Kentucky to be assessed by the State Board of Valuation and Assessment. The Auditor was required to certify this assessment to the county clerks of various counties in which any such institution is situated, who, in turn, were to certify the valuation to the various local tax collectors for the county, city, and local districts.¹⁴⁵

¹⁴⁵ Act of Mar. 21, 1904, 1904 Ky. Acts 66, at 145. The 1904 General Assembly also provided that each city was authorized to "raise a revenue from *ad valorem* taxes and from a tax based on income, licenses and franchises, and to that end . . . may provide for taxation, for municipal purposes, on personal property, tangible and intangible, based on income, licenses or franchises in lieu of an *ad valorem* tax thereon. . . ." Act of Mar. 18, 1904, 1904 Ky. Acts 33, § 1. The Act provided that

[it should not] be so construed as to deprive the General Council of the power hereby granted to it to provide by ordinance in its discretion for the levy and collection of taxes based on income, license and franchises in addition to *ad valorem* taxes on the property of any of the corporations whose franchise is subject to assessment by the City Assessor.

Id. This Act was intended to implement an amendment to section 181 of the Kentucky Constitution, ratified in 1902, authorizing the General Assembly to, in turn, authorize cities to levy taxes on personal property based on income, licenses or franchises, "in lieu of an *ad valorem* tax thereon." *Id.* See Act of Mar. 21, 1902, 1902 Ky. Acts 50, at 100; *George Schuster & Co. v. City of Louisville*, 89 S.W. 689 (Ky. 1905) (municipal authorities are given the option to substitute for the *ad valorem* tax on personal property a tax based on income, licenses or franchises). The city of Louisville sought to levy a tax on the earnings of banks and trust companies which had a place of business within its boundaries. The former Kentucky Court of Appeals noted that any disparate bank taxing scheme under this new authority would be invalid:

By the statute of the United States the national banks are not taxable by the states. The shares of stock may be taxed, but not at a greater rate than is assessed upon other moneyed capital in the hands of individual citizens of the state. Under the statute of the United States no tax can be levied upon national banks, based upon income, licenses, or franchises. Only the shares of stock in the national banks may be taxed, but these cannot be taxed at a greater rate than is assessed upon the state banks and trust companies. If any tax is levied upon national banks under this ordinance, it may be successfully resisted; and if any tax is levied upon the shares of stock of a national bank upon an *ad valorem* assessment, while the state banks are taxed under this ordinance, the assessment would be held void, for the reason that there would be a discrimination in favor of the state banks and trust companies;

Despite the General Assembly's laudable goal of equalizing the tax burden on state and national banks, the bank tax legislation of 1900, 1902, and 1904 failed to adequately resolve the disparities in bank taxation. One notable disparity was the treatment of investments in U.S. securities under this bifurcated tax regime. The federal statute codifying the *Weston* decision exempted U.S. securities from being included in state banks' franchise values. National banks were taxable on their shares, not their franchise, and the State Board of Assessment and Valuation allowed no such exemption from share value. Once again, the banks turned to the courts for relief from this unequal tax treatment. The former Kentucky Court of Appeals, in *Commonwealth v. Citizens' National Bank*,¹⁴⁶ *Citizens' National Bank of Lebanon v. Commonwealth*,¹⁴⁷ and *Marion National Bank of Lebanon v. Burton*,¹⁴⁸ held that inasmuch as the state banks were assessed and taxed on their franchise, and therefore entitled under the law to deduct from the total value of their assets their nontaxable securities, the same right must be accorded to national banks, in order to avoid discrimination.¹⁴⁹ These decisions were a surprising about-face; just nine years earlier the court in *Bank Tax Cases* dismissed the state banks' discrimination argument on ground that the differences between state and national banks justified disparate treatment. The court now dismissed these differences and mandated equal treatment, at least as to federal securities. Further, the court in *Burton* noted that to equalize taxation, "[p]rivate bankers would, of course, have to be put on the same, or at least no more advantageous, plane of taxation."¹⁵⁰

VI. 1906-1916:

RETURN OF THE UNIFORM TAX SYSTEM—BANKSHARES

The General Assembly was in session when the decision in *Burton* was rendered. The court had not only pointed out the defect in existing laws

for in that event the national banks, when they paid upon the value of their shares of stock, would be taxed at a much higher rate than the state banks and trust companies.

Id. at 693-94.

¹⁴⁶ *Commonwealth v. Citizens' Nat'l Bank*, 80 S.W. 159 (Ky. 1904).

¹⁴⁷ *Citizens' Nat'l Bank of Lebanon v. Commonwealth*, 80 S.W. 479 (Ky. 1904).

¹⁴⁸ *Marion Nat'l Bank of Lebanon v. Burton*, 90 S.W. 944 (Ky. 1906).

¹⁴⁹ *See also Farmers' Nat'l Bank v. Commonwealth*, 80 S.W. 1193 (Ky. 1904); *Marion Nat'l Bank v. Commonwealth*, 80 S.W. 1193 (Ky. 1904).

¹⁵⁰ *Burton*, 90 S.W. at 950.

with reference to the taxation of banks, but had also indicated the manner in which the law could be corrected. Taking its cue, the General Assembly enacted two acts during its 1906 Regular Session, including the Act of March 15, 1906 ("Act of 1906"), conforming the taxing statutes to the court's holding and removing the last vestiges of discrimination in the taxation of state and national banks.¹⁵¹

¹⁵¹ Act of Mar. 17, 1906, 1906 Ky. Acts 44, at 278; Act of Mar. 15, 1906, 1906 Ky. Acts 22, at 88. The Act of March 15, 1906 provided as follows:

§ 1. An annual tax, at the same rate which may be fixed by law upon other personalty for State purposes, is hereby imposed upon each one hundred dollars of value of the shares of State banks and trust companies, incorporated under the laws of this Commonwealth, and of National banks doing business therein, and such tax shall be paid to the Treasurer of the State annually by such banks and trust companies for and on behalf of the owners of such shares of stock; and in addition thereto the said banks and trust companies shall pay to the local authorities in counties, cities, towns and districts taxes at the same rate imposed upon other personalty therein.

§ 2. In order to determine the value of the shares of such trust companies, State and National banks, and to assess all shares of such State and National banks and trust companies for State purposes, it shall be the duty of the president, cashier or other chief officer of each State bank, trust company and National bank in this State, annually, between the first day of September and the first day of March, to make and deliver to the Auditor of Public Accounts a statement, verified by its president, cashier or other chief officer, in such form as the Auditor may prescribe, showing the following facts, to-wit: The name and post-office address of the bank or trust company; the names of the president, cashier and board of directors thereof; the number of shares of stock, and the par and market value of each share; the amount of surplus fund and undivided profits; the amount of value of all real estate situated in this Commonwealth, held and owned by the bank or trust company on the first day of September of each year; the amount of its loan and discounts; the amount of its deposits, and such other information as the Auditor may require.

§ 3. The Auditor, Treasurer and the Secretary of State are hereby constituted a Board of Valuation and Assessment for the purpose of fixing the value of shares of all trust companies, State and National banks in this Commonwealth. It shall be the duty of the Auditor, immediately after the Board of Valuation and Assessment has fixed the value of the shares of such trust companies and banks, to furnish each bank and trust company with a statement of the value fixed on its shares and the amount of tax due to the State thereon; and the bank and trust company, and their shareholders, shall have thirty days from the time of receiving the notice by such bank or trust company to go before the board and ask for a change in the valuation of such shares of stock, and the board, after hearing such evidence

as may be submitted, may change the valuation and assessment as it may deem proper, and the action of the board shall be final, and the same shall be certified to the county clerks of each county in this State and filed as a record of his office. Each bank and trust company shall be entitled to have deducted from the total valuation placed on its shares by said board the assessed value of its real estate in this State. It shall be the duty of the trust company and banks to list with the county assessor of each county and with the assessing officer in each city, town and taxing district its real estate and pay the taxes thereon to the sheriff and to the collecting officer of each city, town and taxing district. Any bank or trust company failing, through its officers, to make the report and pay the taxes as herein provided for, shall be liable to such penalties and fines as are imposed by law for such failure on the part of corporations in this Commonwealth required to make such reports and pay taxes to the Treasurer thereof. Said fines and penalties shall be recovered under indictment in the Franklin Circuit Court. Taxes due to the State by trust companies, State and national banks, imposed by this law, shall be payable directly into the State Treasury by the banks and trust companies, on or before the first day of July next succeeding such report, and taxes to counties, cities, towns and districts shall be paid at the time fixed by law for the payment of like taxes.

§ 4. Every State bank and trust company incorporated under the laws of this Commonwealth, and every national bank doing business therein and located in any county, city, town or taxing district in this Commonwealth shall make to the assessing officer of the county, city, town or taxing district a report similar to that required by this subdivision to be made to the State Board of Valuation and Assessment for assessment for State purposes. The assessing officer of the county, city, town or taxing district wherein any trust company, State and national bank is situate, shall assess the shares of such trust company, State and national bank for taxation for county, city, town and taxing district purposes in the manner prescribed in this subdivision for assessing the same by the State Board of Valuation and Assessment for taxation for State purposes, and such officer shall make out and return the assessment to the proper authorities of the county, city, town or taxing district, at the same time and manner as prescribed by law for the return of the assessment of personal property therein. In assessing the shares of banks for county purposes the assessor shall make the return upon a separate blank and shall not be included in the recapitulation sheet made by the county clerk and furnished to the auditor, but shall be returned to the county board of supervisors. The equalization, collection, penalties and all laws relating thereto, now provided by law for other personal property in the county, city, town or taxing district, shall apply in like manner to the collection of the taxes herein provided for; any county, city, town or taxing district, not now having the right to collect such taxes by suit, is hereby authorized and empowered so to do. Nothing herein shall be construed to repeal or amend chapter thirty-three of the Acts of 1904, approved March 18, 1904, entitled

The General Assembly first addressed private banks by requiring all banking businesses to incorporate.¹⁵² The legislature found the addition of this requirement to be the most expedient means to comply with the *Burton* decision, stating, "Under opinion of the court of appeals it being necessary that all banking business shall be conducted by incorporated banks in order to render taxation of banks equal in this Commonwealth."¹⁵³

The General Assembly also addressed the unequal treatment of state and national banks by repealing state and local franchise taxes on state banks¹⁵⁴ and subjecting Kentucky banks to tax on the value of their shares in the same manner that national banks had been assessed under the Act of 1904. Despite *Weston*, this new regime denied both state and national banks any deduction for the value of their investments in U.S. securities. Further, the legislature returned state and national banks to a multi-tiered valuation regime, under which their shares were to be valued by the State Board of Valuation and Assessment for state purposes, and by the county, city, town, or taxing district authorities in which the bank was situated for local purposes.¹⁵⁵ Both state and national banks remained taxable on their tangible property.¹⁵⁶

An Act to amend the revenue laws of the cities of the first class so as to carry into effect the amendment of section 181 of the present Constitution.

§ 5. All laws or parts of laws in conflict or inconsistent with this act, providing for other methods of taxation of shares of national banks or the taxation of trust companies and State banks, incorporated under the laws of this Commonwealth, and the collection of taxes thereon, are hereby repealed.

§ 6. All national banks, trust companies and State banks shall file with the Auditor their reports herein provided for on or before the 15th day of April, 1906, and annually thereafter on or before March the first. Said reports shall be made up to and including the first day of the preceding September.

Act of Mar. 15, 1906, 1906 Ky. Acts 22, Art. IV, subd. 2.

¹⁵² Act of Mar. 17, 1906, 1906 Ky. Acts 44, at 278. Previously, private banking had been penalized but not prohibited outright. See *supra* note 11.

¹⁵³ Act of Mar. 17, 1906, 1906 Ky. Acts, § 4.

¹⁵⁴ Act of Mar. 15, 1906, 1906 Ky. Acts 22, Art. IV, subd. 2, § 5.

¹⁵⁵ At least one authority states that such shares were valued at par value plus eighty percent of the bank's surplus and undivided profits. STATE TAX LEAGUE, TAXATION OF REAL ESTATE AND PERSONAL PROPERTY IN KENTUCKY 56 (1916) [hereinafter 1916 TAX STUDY]. However, most tangible property was assessed at a much smaller percentage of value. *Id.* at 59.

¹⁵⁶ The General Assembly also expanded to all financial institutions the credit mechanism originally provided in 1900 for banks that had paid higher taxes under the Hewitt Act than under the general revenue law. See Act of Mar. 22, 1906, 1906 Ky. Acts 136, at 465. Presumably this was intended for unincorporated, private banks.

One final challenge remained. The national bank that had challenged the disallowance of a deduction for U.S. securities under the Act of 1900 once again challenged the now evenhanded disallowance under the new regime. In *Hager v. Citizens' National Bank of Lebanon*,¹⁵⁷ the former Kentucky Court of Appeals held that the tax levied in 1906 was in fact upon the bank's shares, not its assets, and therefore no deduction from the state bankshares tax was required.¹⁵⁸ The court in *Hager* did, however, grant some relief. Although the Act of 1906 did not provide that banks could charge the tax to their shareholders, the court held that "the unequivocal right of recovery [from shareholders] exists under our act, although not given in express terms."¹⁵⁹ Peace thereafter reigned in the banking industry for ten years.

VII. 1917-1984:

IMPLEMENTATION OF CONSTITUTIONAL AMENDMENT— CLASSIFICATION OF PROPERTY FOR TAX PURPOSES

There was general dissatisfaction with Kentucky's tax system at the beginning of the nineteenth century. The state and local governments were at that time relying overwhelmingly upon property taxes to generate public revenue. Governor Augustus Willson responded to this general public angst by directing in December, 1908 that a study of Kentucky's tax system be made. At his direction, an Advisory Commission was formed to ascertain what was needed to improve the state's system of taxation and a Tax Commission was formed to draft legislation based upon the Advisory Commission's findings. The two Commissions issued a joint report in December, 1909 detailing their findings and proposing constitutional changes to address the perceived problems.¹⁶⁰ Subsequent Tax Commissions formed in 1912 and 1914 issued nearly identical reports.

A. Commission Findings

The Commissions of 1908, 1912, and 1914 each identified section 171 of the Kentucky Constitution to be the primary source of the public

¹⁵⁷ *Hager v. Citizens' Nat'l Bank of Lebanon*, 105 S.W. 403 (Ky. 1907).

¹⁵⁸ See also *Richardson v. State Nat'l Bank*, 123 S.W. 294 (Ky. 1909) (upholding the disallowance of this deduction for local tax purposes).

¹⁵⁹ *Hager*, 105 S.W. at 409.

¹⁶⁰ TAX COMMISSION, TAX REVISION: STATE OF KENTUCKY (1909) [hereinafter 1909 TAX STUDY].

dissatisfaction. At that time, section 171 required that all "[t]axes shall be uniform upon all classes of property within the territorial limits of the authority levying the tax." Thus, all property, whether real, tangible personal, or intangible, was subject to the same rate of taxation. The net result of this "Constitutional straight jacket"¹⁶¹ was that "an unfair proportion of the burden of government [was] borne by visible property, which cannot escape taxation, and wholesale evasion by such forms of property as are easily hidden."¹⁶² To address this problem, the Commissions recommended an amendment to section 171 which would empower the General Assembly to levy different tax rates upon different classes of property and to limit the power of local governments to tax certain classes of property.

The 1909 Commission, in its Joint Report to the Governor, addressed at some length the effect of Kentucky's then-current system of taxation upon bank deposits and bank shares and recommended that the rates applicable to each be reduced. The high rate of taxation on bank deposits had caused many persons to remove their funds from banks prior to September 1, the assessment date, to avoid reporting.¹⁶³ Additionally, the high rate of taxation confiscated the majority of the interest income earned on savings and impelled persons to evade listing deposits or, alternatively, to spend their excess funds as opposed to saving or investing them.¹⁶⁴ As to the bankshares tax, the Commissions found that banks decreased their

¹⁶¹ TAX COMMISSION, REPORT OF KENTUCKY STATE TAX COMMISSION 15 (1913) [hereinafter 1913 TAX STUDY] (emphasis omitted).

¹⁶² 1909 TAX STUDY, *supra* note 160, at 3-4. Additionally, it appears that assessors were assessing intangible personal property at 100% of its face value while other forms of property were assessed at substantially lower percentages. 1913 TAX STUDY, *supra* note 161, at 8. It was later claimed that "the State of Kentucky received more revenue for the year 1912 from its dogs than it did from all the bonds, money and stocks in the State." *Id.* at 7. Indeed, it was noted that "[t]he chief tax, called a general property tax, levied by the State, has, under the system by which it has been enforced, practically become a real estate tax as only a very small per cent of the entire taxes are levied on personal property." *Id.* at 21.

¹⁶³ 1909 TAX STUDY, *supra* note 160, at 9-10 ("During the latter part of August in every year hundreds of thousands of dollars are withdrawn from the banks and invested in government bonds and similar non-taxable securities, in order to escape taxation on cash balances."). One report states that in 1915, the amount of bank deposits in Kentucky listed for taxation was approximately \$11 million while the reports to the Banking Commissioner noted the amount of bank deposits to be \$140 million. 1916 TAX STUDY, *supra* note 155, at 15.

¹⁶⁴ 1909 TAX STUDY, *supra* note 160, at 10-11.

capital to lower the taxable value of their shares, resulting in undercapitalization and lack of funds needed by borrowers.¹⁶⁵ Any tax actually paid by the banks on behalf of their shareholders was ultimately passed through to borrowers in the form of higher interest rates.¹⁶⁶ Reducing the tax rates applicable to these classes of property would substantially increase reporting and, it was thought, overall revenue.¹⁶⁷

Another legislatively-appointed tax commission studied the Kentucky tax system again in 1912 to generate public support for an amendment to section 171 of the Kentucky Constitution.¹⁶⁸ Its report was widely disseminated and, in the November, 1915 elections, the Kentucky voters approved the amendment to section 171, which was uniformly recommended by the Commission.¹⁶⁹

¹⁶⁵ *Id.* at 12-13.

¹⁶⁶ *Id.* ("The burden does not fall upon stockholders of the banks, for the banks, by decreasing capital, or charging higher rates for the use of money, continue to earn and pay dividends—it falls always upon the borrower.").

¹⁶⁷ *Id.* at 26; 1916 TAX STUDY, *supra* note 155, at 7.

¹⁶⁸ See 1912 Ky. Acts (House Res. 24), at 680 ("Said commission shall investigate revenue and taxation in this State and recommend a plan for the revision thereof. Said commission shall investigate the sources of revenue in this State and what requirements are necessary, if any, and shall also investigate the laws of other States."). The first attempt to amend section 171 of the Constitution was rejected by Kentucky voters in the November, 1913 elections. See 1912 Ky. Acts 34, at 151. The second attempt in 1915 was successful.

¹⁶⁹ See 1916 TAX STUDY, *supra* note 155, at 2. The amendment provided as follows:

The General Assembly shall provide by law an annual tax, which with other resources, shall be sufficient to defray the estimated expenses of the Commonwealth for each fiscal year. Taxes shall be levied and collected for public purposes only and shall be uniform upon all property of the same class subject to taxation within the territorial limits of the authority levying the tax; and all taxes shall be levied and collected by general laws.

The General Assembly shall have power to divide property into classes and to determine what class or classes of property shall be subject to local taxation. Bonds of the State and of counties, municipalities, taxing and school districts shall not be subject to taxation.

Any law passed or enacted by the General Assembly pursuant to the provisions of or under this amendment or amended section of the Constitution, classifying property and providing a lower rate of taxation on personal property, tangible or intangible, than upon real estate, shall be subject to the referendum power of the people, which is hereby declared to exist to apply only to this section, or amended section. The referendum may be demanded by the people against one or more items, sections or parts of any Act

The General Assembly began efforts early in 1916 to exercise its new constitutional authority, organizing yet another tax commission to study how Kentucky's tax system should be reformed.¹⁷⁰ This commission was charged "to investigate the taxation methods of this and other states and to prepare a new law on revenue and taxation in conformity with the Constitution of this Commonwealth."¹⁷¹ Its report was submitted in October of 1916 and recommended that the state tax rate on bank deposits be lowered substantially:

The only instance in which the Commission recommend a different rate for State purposes, upon a particular class of property, is in the case of bank deposits, and then because it realizes that money in bank is the medium of commerce and trade and should be encouraged to accumulate in the greatest possible quantities in order that it may be loaned by the

enacted pursuant to or under the power granted by this amendment, or amended section. The referendum petition shall be filed with the Secretary of State not more than four months after the final adjournment of the Legislative Assembly which passed the bill on which the referendum is demanded. The veto power of the Governor shall not extend to measures referred to the people under this section. All elections on measures referred to the people under this Act shall be at the regular general elections, except when the Legislative Assembly shall order a special election. Any measure referred to the people shall take effect and become a law when approved by the majority of the votes cast thereon, and not otherwise. The whole number of votes cast for the candidates for Governor at the regular election last preceding the filing of any petition shall be the basis upon which the legal voters necessary to sign such petition shall be counted. The power of the referendum shall be ordered by the Legislative Assembly at any time any acts or bills are enacted, pursuant to the power granted under this section or amended section, prior to the year of one thousand nine hundred and seventeen. After that time, the power of the referendum may be ordered either by the petition signed by five percent of the legal voters or by the Legislative Assembly at the time said acts or bills are enacted. The General Assembly enacting the bill shall provide a way by which the act shall be submitted to the people. The filing of a referendum petition against one or more items, sections or parts of an Act, shall not delay the remainder of that Act from becoming operative.

1914 Ky. Acts 94, at 497 (emphasis added). An identical amendment passed by the General Assembly in 1912 apparently was not enacted when submitted to the voters. See 1912 Ky. Acts 34, at 151.

¹⁷⁰ This was also the recommendation of the Advisory Commission and Tax Commission. See 1916 TAX STUDY, *supra* note 155, at 80.

¹⁷¹ Act of Mar. 23, 1916, 1916 Ky. Acts 137, at 726.

banks and used by those needing money for the development of all enterprises and resources within the State. The Commission has therefore concluded to recommend a nominal tax of ten cents for State purposes only on each one hundred dollars on deposit in bank.¹⁷²

The Commission reiterated the widely held belief that the amount of bank deposits listed for taxation under this lower rate would actually increase overall the amount of state taxes received from this class of property. The Commission further recommended charging the banks with the reporting and remittance of this tax on behalf of depositors.¹⁷³

B. 1917: Introduction of Property Classification

The General Assembly implemented its new constitutional power in a special legislative session called in 1917 for the sole purpose of considering the Commission's report and the subject of Kentucky's revenue and system of taxation. Two acts passed during this special session directly impacted the taxation of banks and their depositors.¹⁷⁴

The first of these acts lowered the generally applicable state property tax rate to \$0.40 on each \$100 of value and exempted intangible personal property from local taxation.¹⁷⁵ The second placed in-state bank deposits in a special class for purposes of taxation.¹⁷⁶

All state and national bankshares were ostensibly subject to the general state rate of \$0.40 on each \$100 of value.¹⁷⁷ The General Assembly authorized the assessing officer of the county, city, town, or taxing district in which the bank was located to value a bank's shares for state and local taxation, which valuation was subject to equalization.¹⁷⁸ The shares of banks that paid tax in Kentucky on at least twenty-five percent of their property were exempted from being listed for taxation, and therefore,

¹⁷² 1916 TAX STUDY, *supra* note 155, at 8-9.

¹⁷³ *Id.*

¹⁷⁴ See Act of May 2, 1917, 1917 Ky. Acts (Ex. Sess.) 4, at 27; Act of May 2, 1917, 1917 Ky. Acts (Ex. Sess.) 11, at 44.

¹⁷⁵ Act of May 2, 1917, 1917 Ky. Acts (Ex. Sess.) 11, §§ 1, 4.

¹⁷⁶ Act of May 2, 1917, 1917 Ky. Acts (Ex. Sess.) 4, at 27.

¹⁷⁷ The state rate levied under the Act of 1906 was \$0.50 per \$100 of taxable share value. See Act of Mar. 15, 1906, 1906 Ky. Acts 22, Art. I, § 1. This rate was subsequently raised to \$0.55 per \$100, until the 1917 legislation reduced the amount of the state-level bankshares tax to \$0.40 per \$100.

¹⁷⁸ Act of May 2, 1917, 1917 Ky. Acts (Ex. Sess.) 11, § 4.

effectively exempted from taxation.¹⁷⁹ Thus, shares of stock in Kentucky banks were effectively exempt from taxation while shares in out-of-state banks remained taxable.¹⁸⁰ Tangible property owned by banks remained fully taxable.

The General Assembly also addressed the State Tax Commission's concerns regarding the underreporting of bank deposits (and other classes of intangible property) by completely revising the method of assessing and collecting the tax on this class of property. The new statutes bifurcated the taxation of deposits held by in-state banks and those held by out-of-state banks. Deposits in any bank "organized under the laws of this State" or in any "national bank in this State" were subject to a uniform, low state tax rate and exempted from local taxation.¹⁸¹ Banks were required to report deposits and pay taxes thereon on behalf of their depositors at the nominal rate of 0.1% of the amount of the deposits.¹⁸² This tax could, at the bank's option, be charged against the deposit, and banks were granted a statutory lien to enforce this right to pass through the deposits tax. Any such charge was required to be deducted from the deposit within six months of payment.

Deposits in other banks, i.e., out-of-state banks, were taxable directly to the Kentucky resident depositors at the general \$0.40 state rate. Like in-state deposits, these deposits were also exempt from local taxation. For the first time since the passage of the Hewitt Act and the end of charter taxing

¹⁷⁹ *Id.* § 3. This exemption provision applied to shares in all corporations, not just banks, and was much broader than the limited exemption enacted in 1892. *See supra* note 102. For a detailed history of this provision, see Alsip et al., *supra* note 108, at 1053.

¹⁸⁰ One treatise reports that the receipts from the state bankshares tax dropped dramatically with the enactment of these changes in 1917. According to 1 SIMEON E. LELAND, *TAXATION IN KENTUCKY*, Table II (1920), the state derived \$10,015.42 from the bankshares tax in 1918, a substantial reduction from the \$258,587.55 derived in the previous year.

¹⁸¹ The 1917 General Assembly exempted in-state bank deposits and most other intangible personal property from local taxation. The local tax on national bankshares, despite the exemption of many classes of intangible personal property from local taxation, was subsequently held not to violate the National Bank Act's restrictions on state and local taxation. *See McFarland v. Georgetown Nat'l Bank*, 270 S.W. 995 (Ky. 1925). *See also City of Richmond v. Madison Nat'l Bank & Trust Co.*, 284 S.W. 1089 (Ky. 1926).

¹⁸² Act of May 2, 1917, 1917 Ky. Acts (Ex. Sess.) 4 (originally codified at K.S. § 4019a-1 to -4 (Baldwin 1922)).

provisions, bank deposits were once again exempted from local taxation.¹⁸³ Therefore, depositors choosing out-of-state banks that voluntarily listed their deposits for taxation were subject to a 400% greater state tax burden.

Despite the clear discrimination, the new reporting and payment mechanism was actually intended to increase compliance, particularly with out-of-state depositors, as well as to ease administration.¹⁸⁴ The State Tax Commission had clearly found ineffective the prior regime of depositor voluntary compliance. Further, the myriad reported decisions of enforcement actions against deposit tax evaders evidence the difficulty and expense of administering the prior regime.¹⁸⁵ The new reporting and payment system arguably would not only address the cause of these problems prospectively, but would also allow state taxing authorities to derive a list of persons who had likely failed to list their deposits in previous assessment years.

C. "Carrot" and "Stick"

There were two unusual provisions in the 1917 legislation. The first expanded the period in which intangible property could be assessed for back taxes. The second offered taxpayers an "amnesty" with respect to certain intangibles listed in 1917.

The new reporting and payment provisions took effect on May 2, 1917, and required banks to list by September 21 the deposits on hand as of September 1.¹⁸⁶ The legislation further authorized the state and local taxing districts to retroactively assess "money in hand, notes, bonds, accounts, or other credits, secured or unsecured, or shares of stock liable to assessment"

¹⁸³ Act of May 2, 1917, 1917 Ky. Acts (Ex. Sess.) 11, § 4(3), exempted, among other property, certain intangible property from local taxation as follows:

Money in hand, notes, bonds, accounts and other credits, whether secured by mortgage, pledge or otherwise, or unsecured. Shares of stock not [otherwise] relieved from [taxation] . . . provided, however, that nothing in this section shall forbid local taxation of franchises of corporations or of the shares of banks, trust companies, or combined banks and trust companies doing business in Kentucky

¹⁸⁴ Seventy-eight years after its enactment, the Kentucky Supreme Court, in 1995, held that this facial discrimination against deposits held by out-of-state banks violated the Commerce Clause and invalidated the bank deposits tax. *See St. Ledger v. Kentucky Revenue Cabinet*, 912 S.W.2d 34, 39 (Ky. 1995), *vacated by* 517 U.S. 1206 (1996).

¹⁸⁵ *See supra* note 25.

¹⁸⁶ 1917 Ky. Acts (Ex. Sess.) 11, § 6.

which had not been listed for taxation in the last ten years.¹⁸⁷ In addition to back taxes, such retroactively assessed "omitted property" was subject to a 100% penalty and six percent interest from the time such taxes should have been paid.¹⁸⁸ The legislation effectively offered bank deposit tax evaders a three month window in which to move their accounts to out-of-state banks and thereby avoid the mandatory listing of their deposits by Kentucky banks.¹⁸⁹

The new statute contained as part of the penalty provision the following proviso to induce certain property owners to list their property and, arguably, would-be deposit tax evaders to keep their funds in the state:

Provided, further, that after September 1st, 1917, no action shall be commenced nor proceeding taken on behalf of the State or any county, city, town, or taxing district to assess for taxation for any period prior to September 1st, 1917, any personal property described in this section [money in hand, notes, bonds, accounts and other credits, whether secured by mortgage, pledge, or otherwise, or unsecured, and shares of stock not otherwise exempted from taxation] required to be listed for taxation which had theretofore been omitted or which may be claimed to have been omitted, if such property has been so listed for taxation as of September 1st, 1917; nor shall any pending action, prosecution, or proceeding be amended so as to include any such personal property listed as of said date.¹⁹⁰

Thus the statute appeared to preclude an action to recover prior years' state or local taxes on "accounts" or "credits" if such property was listed for the 1917 assessment year. Whether many depositors who had previously evaded the bank deposits tax were persuaded falsely by this provision to maintain their deposits in Kentucky banks is unclear. Three years later, however, the former Kentucky Court of Appeals, in *Commonwealth v. Alford's Executor*,¹⁹¹ held that bank deposits were not "accounts" or "credits" within the meaning of the statute and, therefore, could be

¹⁸⁷ *Id.*

¹⁸⁸ *Id.* See *Commonwealth v. Perkins' Ex'r*, 256 S.W. 711, 712 (Ky. 1923) ("Prior to the passage of the statute, the right of a revenue agent to assess retroactively omitted property under the provisions of [the statute] . . . was barred, under numerous opinions of this court, if not instituted within five years from the time when the right to do so first accrued.").

¹⁸⁹ 1917 Ky. Acts (Ex. Sess.) 11, § 6.

¹⁹⁰ *Id.*

¹⁹¹ *Commonwealth v. Alford's Ex'r*, 218 S.W. 721 (Ky. 1920).

retroactively assessed and their owners penalized.¹⁹² The deceased taxpayer involved in the action was held liable for taxation on the deposits she failed to list for the 1912 through 1916 assessment years.¹⁹³

Ostensibly, the bank deposit tax levied in 1917 was to be remitted by the banks but borne by depositors. By at least 1920, however, it was commonplace for the banks to absorb this tax, not pass it through to their customers.¹⁹⁴

The lowered rate as well as the new reporting and payment mechanisms proved successful. State tax revenue from bank deposits increased over \$117,000 in 1917.¹⁹⁵ Overall, however, the changes

¹⁹² *Id.* at 723. The court noted that “the Legislature of this State for a great number of years has recognized bank deposits as a species of property separate and distinct from what is generally included by the terms ‘accounts’ or ‘credits.’” *Id.* As further justification, the court reasoned as follows:

Past experience had demonstrated that a large amount of intangible property, consisting of “money in hand, notes, accounts, and other credits,” had been secreted and withheld from assessment by the owner, and to induce him to bring that character of property to the light and assess it for taxation he was offered the exemption therein provided. Not so with bank deposits, which could, most likely, be discovered by the diligent assessing officer.

Id. The court ignored the difficulty an assessing auditor would have discovering bank deposits held in banks outside of Kentucky.

¹⁹³ *Id.* at 721.

¹⁹⁴ LELAND, *supra* note 180, at 27 (“In actual practice the banks do not charge the tax against the depositors but pay the tax themselves, thereby using the tax as a means to encourage deposits.”).

¹⁹⁵ The State Tax Commission, the new state administrative agency created in 1917 to oversee, among other things, the bank deposits tax reported the following results:

The total deposits with banks and trust companies were assessed for taxation under the old law as of September 1, 1916, at \$11,277,196, which was higher than for any previous year. The tax to the State on deposits assessed last year at a tax rate of fifty-five cents was \$62,024.59, while the tax to the State this year on a ten cents rate is \$179,147.31, or a net increase to the State of \$117,122.72.

REPORT OF STATE TAX COMMISSION 6 (1917); *see also* KENTUCKY STATE TAX COMMISSION, FIRST ANNUAL REPORT 5 (1918); *but see* REVENUE AND TAXATION: A REPORT BY THE EFFICIENCY COMMISSION OF KENTUCKY 29 (1923) (“Even a nominal rate of tax, ten mills for State purposes and no tax for local purposes, is apparently not successful in securing complete assessment.”). The amount of intangible personal property listed for taxation in 1918 was 258.8% higher than in 1917. KENTUCKY STATE TAX COMMISSION, *supra*, at 6.

wrought by the General Assembly in 1917 were disastrous to state revenue.¹⁹⁶

D. Rate Revisions of 1924 and 1926

Seven years later, the General Assembly once again exercised its authority to deal with property within classes, creating a special tax rate regime for bankshares, increasing the state tax burden borne by this property and lowering the local tax burden. With the Act of March 14, 1924 ("Act of 1924"), the state rate on shares of stock in state and national banks was raised to \$0.50 on each \$100 of fair cash value.¹⁹⁷ Counties and towns were limited to levying a rate of \$0.20 each, and schools to a rate of \$0.40.¹⁹⁸ Thus, the Act of 1924 established a ceiling on the combined state and local tax on shares of \$1.30 per \$100 value. The Act specified that the tax was imposed upon shares of stock of state banks incorporated under the laws of Kentucky and national banks doing business in Kentucky. These state and local taxes were paid by the banks and trust companies for and on behalf of their stockholders.¹⁹⁹ Taxes on shares of stock in out-of-state banking institutions were presumably subject to this rate regime and continued to be collected from the shareholders.

The General Assembly refrained from amending the tax regime applicable to banks for the next forty-two years. When the state income tax was first levied in 1936, banks and trust companies were specifically exempted from its provisions.²⁰⁰ Further, dividends paid on bank stock were excluded from the income of stockholders.²⁰¹ This special treatment afforded banks, trust companies, and their stockholders was specifically upheld by the former Kentucky Court of Appeals.²⁰²

¹⁹⁶ The 1917 legislation substantially reduced the applicable state tax rate on other classes of intangible personal property. The Tax Commission estimated the total loss in state revenue as the result of the rate reductions to be \$1.9 million. REPORT OF STATE TAX COMMISSION, *supra* note 195, at 11.

¹⁹⁷ Act of Mar. 14, 1924, 1924 Ky. Acts 117, at 415.

¹⁹⁸ *Id.* at 416.

¹⁹⁹ *Id.*

²⁰⁰ 1936 (3d Ex. Sess.) Ky. Acts 7, § 14(3).

²⁰¹ *Id.* § 3(1)(k).

²⁰² See *Reynolds Metal Co. v. Martin*, 107 S.W.2d 251 (Ky. 1937). The court held that the Depression-era economic conditions warranted special treatment for financial institutions. "[B]anks . . . must, over a period of time, operate at least without loss, and if their organization and continuance are to be expected and encouraged, a reasonable profit must be theirs." *Id.* at 262. As to the exemption for

With the exception of rate changes, Kentucky's method of taxing incorporated banking institutions remained largely unchanged between 1906 and 1984.²⁰³ No significant constitutional challenges arose during that period. Most litigation in those years was limited to issues of valuation.²⁰⁴

VIII. 1984 TO 1994: ADJUSTMENTS RELATING TO FEDERAL OBLIGATIONS AND STATUS QUO

Despite subsequent rate changes, no substantial judicial decisions or statutory changes involving the bank tax structure occurred between 1924 and 1995. The state and the banking industry appeared to have reached an uneasy truce with respect to Kentucky's bank tax system in this modern era of banking. The sole impetus for change proved to be changes in the banking industry itself. The expansion of banking activities and the deregulation of the banking industry has, with one exception, proven the primary catalyst for legislation during this period.

The one exception in this otherwise uneventful period occurred in 1984. From 1906 through 1984, Kentucky allowed no deduction from the value of bankshares for the value of the bank's investments in nontaxable U.S. securities. Consistent with the decision of the U.S. Supreme Court in *Van Allen v. The Assessors*,²⁰⁵ the former Kentucky Court of Appeals had

dividends, the court found that "[t]he same consideration supports the exemption . . . since the purpose of such exemption was to encourage the investment of money in bank stocks to the end that banks may be organized, enlarged and even refinanced to discharge [their] functions. . . ." *Id.*

²⁰³ In 1966, the state, city, county, and school tax rates on bank and trust company shares were reduced to \$0.475, \$0.19, and \$0.38 per \$100 of fair cash value for state, county and city, and school purposes. 1966 Ky. Acts 159, § 1. In 1976, the state and school tax rates were combined by adding the school rate to the state rate. 1976 Ky. Acts 93, § 12.

²⁰⁴ See, e.g., *Owensboro Nat'l Bank v. Dep't of Revenue*, 394 S.W.2d 461 (Ky. 1965); *Cook v. Citizens State Bank of Wickliffe*, 304 S.W.2d 931 (Ky. 1957); *Ballard County v. Citizens State Bank of Wickliffe*, 261 S.W.2d 420 (Ky. 1953); *Bd. of Supervisors v. State Nat'l Bank of Frankfort*, 189 S.W.2d 942 (Ky. 1945); *Larue County Bd. of Supervisors v. Lincoln Nat'l Bank of Hodgenville*, 187 S.W.2d 819 (Ky. 1945); *Greensburg Deposit Bank v. Commonwealth*, 20 S.W.2d 979 (Ky. 1929); *Farmers' Nat'l Bank of Somerset v. Bd. of Supervisors*, 8 S.W.2d 401 (Ky. 1928); *Caldwell County v. First Nat'l Bank*, 152 S.W. 757 (Ky. 1913).

²⁰⁵ *Van Allen v. The Assessors*, 70 U.S. 573 (1865).

upheld this method of taxation in *Hager v. Citizens' National Bank of Lebanon*,²⁰⁶ and *Richardson v. State National Bank*.²⁰⁷

In *American Bank & Trust Co. v. Dallas County*,²⁰⁸ the U.S. Supreme Court reversed itself. The action involved a challenge to a Texas property tax on state and national bankshares computed on the basis of each bank's net assets without any deduction for the value of U.S. obligations.²⁰⁹ The Court struck down the Texas tax scheme, holding that the 1959 amendment to 31 U.S.C. § 742 set aside the Court's pre-1959 interpretation that the statute did not prohibit nondiscriminatory taxes imposed on discrete property interests such as corporate shares, even though the value of that discrete interest was measured by the underlying assets, including U.S. obligations.²¹⁰ The Court construed the 1959 amendment as barring a tax, regardless of its form, if federal obligations must be considered either directly or indirectly in computing the tax.²¹¹

The 1984 General Assembly responded to the action of the U.S. Supreme Court by substantially revising the method of valuing bankshares. The tax base was changed to conform to *American Bank & Trust Co.* through a complicated statutory formula that provided for calculating the fair cash value of shares of stock. The tax was no longer to be levied on the "fair cash value" of such shares, but on their "*taxable* fair cash value," defined as follows:

"Taxable fair cash value of shares" shall mean the fair cash value of shares of stock of state banks and trust companies incorporated under the laws of this state and of national banks doing business in this state reduced by the influence of tax exempt United States obligations.²¹²

The General Assembly also altered the rate structure such that the state rate on shares was increased to \$0.95, and the maximum local tax rates were adjusted to avoid any reduction in revenue as the result of the newly mandated deduction from the tax base.²¹³

To prevent banks from raiding state and local treasuries for pre-1984 taxes, the General Assembly also enacted a unique provision that levied a

²⁰⁶ *Hager v. Citizens' Nat'l Bank of Lebanon*, 105 S.W. 403 (Ky. 1907).

²⁰⁷ *Richardson v. State Nat'l Bank*, 123 S.W. 294 (Ky. 1909).

²⁰⁸ *Am. Bank & Trust Co. v. Dallas County*, 463 U.S. 855 (1983).

²⁰⁹ *Id.* at 857.

²¹⁰ *Id.* at 872-73.

²¹¹ *Id.*

²¹² 1984 Ky. Acts 264, § 1(3).

²¹³ *Id.* § 2(1).

“contingent tax.” If any bank were to receive a favorable unappealable judgment that the pre-1984 tax on bankshares was deficient by indirectly taxing U.S. securities, a tax would be levied automatically upon all banks equal to \$1.38 per \$100 of the taxable fair cash value of their shares for the year in which refunds were authorized. Similar contingent taxes were authorized for local taxing jurisdictions.²¹⁴

The taxpayer victory in *American Bank & Trust Co.* rang hollow in Kentucky. It appears that, in light of the 1984 statutory amendments, no action challenging the pre-1984 taxing scheme was ever filed. The net effect of the 1984 amendments was to maintain the same level of state and local revenue from the bankshares tax.

IX. HOUSE BILL 416—

BANK FRANCHISE AND LOCAL DEPOSITS TAX ACT OF 1996

Only Kentucky-domiciled banks and trust companies were required to remit tax on the value of their shares as agent for their shareholders. By the end of 1995, a number of problems had arisen with respect to Kentucky's then-current system of bank taxation. The number of challenges by non-publicly traded banks to the Revenue Cabinet's valuation of their bankshares had increased substantially in the wake of the Kentucky Education Reform Act of 1990,²¹⁵ and the reaffirmation of fair market value standard for Kentucky state and local property taxation. In the wake of successive federal legislation easing restrictions on the conduct of certain financial businesses across state lines, a number of out-of-state financial institutions were competing without paying Kentucky tax. Worse still, the passage by the U.S. Congress of the Riegle-Neal Act in 1994,²¹⁶ would likely allow out-of-state bank holding companies to convert their Kentucky bank subsidiaries into branches and thereby completely avoid the bankshares tax. Finally, the *St. Ledger* litigation could potentially extend the high rate on out-of-state deposits to in-state deposits or, alternatively, could throw out Kentucky's tax on bank deposits in its entirety on constitutional grounds.

²¹⁴ *Id.* § 3.

²¹⁵ 1990 Ky. Acts 476, at 1208 (codified as amended in chapters 156-165 and other scattered chapters of K.R.S.).

²¹⁶ Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, Pub. L. No. 103-328, 108 Stat. 2338 (1994) (limiting certain national bank activities to state law and granting states the ability to tax national banks in the absence of expressed federal preemption).

The Kentucky Bankers Association ("KBA") spearheaded an industry initiative to address these issues by reforming Kentucky's taxation of financial institutions. The coordinated efforts of the KBA, the Community Bankers Association, the Revenue Cabinet and the Legislative Research Commission resulted in the drafting, introduction, and ultimate passage of House Bill 416 during the 1996 regular session of the General Assembly.²¹⁷ House Bill 416 repealed the nearly two-century old bankshares tax, enacted a new "franchise tax" on financial institutions and equalized the tax rates on bank deposits. Further, the state's taxing jurisdiction under the new franchise tax was broadened considerably in an attempt to level the competitive playing field by subjecting non-domiciliary financial institutions to Kentucky taxation. This new taxing structure took effect for the 1996 tax year.

A. Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994

The Riegle-Neal Act, the most significant impetus for Kentucky bank tax reform, was landmark legislation that accelerated the movement toward banking and branching across state lines. The Act made two significant changes, broadening both interstate banking powers and interstate branching powers. Effective June 1, 1995, the Riegle-Neal Act authorized bank holding companies to acquire banks in any state regardless of that state's laws concerning interstate acquisitions. Effective June 1, 1997, two years thereafter, bank holding companies owning banks in more than one state were able to merge those banks into a single interstate branch network.²¹⁸

Riegle-Neal's second change was to repeal the McFadden Act of 1927.²¹⁹ Until Riegle-Neal, the McFadden Act had authorized the states to

²¹⁷ Bank Franchise and Local Deposit Tax Act, 1996 Ky. Acts 254, § 2.

²¹⁸ Riegle-Neal Interstate Banking and Branching Efficiency Act § 103, 108 Stat. at 2552.

²¹⁹ Act of Feb. 25, 1927 (McFadden Act), ch. 191, 44 Stat. 1224 (codified as amended at 12 U.S.C. § 36 (2000)). In 1927, Congress passed the McFadden Act, thereby amending the National Bank Act to allow national banks to establish branch banks within the state in which they were located "if such establishment and operation are . . . expressly authorized to State banks by the law of the State in question . . ." *Id.* § 36(c). Although the McFadden Act provided for intrastate branching, it did not empower national banks to operate interstate branches. Until the late 1980s, all states had laws that prohibited interstate branch banking. Nevertheless, banks and bank holding companies were able to engage in interstate branch banking through several loopholes in the federal laws.

determine whether, and to what extent, banks were allowed to branch. With respect to national banks, the McFadden Act limited national banks such that they could branch at most statewide, and in no case across state lines. Prior to Riegle-Neal, no state had authorized interstate branching for its state banks. Thus, banks wishing to conduct interstate banking operations were required to maintain separately incorporated banks in different states of operation, all unified under a common bank holding company. The repeal of the McFadden Act threatened to destabilize Kentucky's system of bank taxation.

The Riegle-Neal Act authorizes a bank to operate branches nationwide. Banking entities may now participate in interstate branching by: (1) consolidating banks with or without a common bank holding company; (2) acquiring an existing bank or branch in the state they wish to enter; or (3) opening a "de novo branch."²²⁰ This broad interstate branching provision is subject to a substantial caveat—an opt-out clause allowing states to prohibit interstate branching. Riegle-Neal permits banks to engage in interstate branching if both the "home state" and the "host state" have opted in to the Act. States had until June 1, 1997 to either opt in or out of the Act's interstate branching provisions within their borders.²²¹

In summary, the Riegle-Neal Act allows existing bank holding companies to merge their subsidiary banks into one single bank subsidiary,

²²⁰ *Id.*

²²¹ Riegle-Neal Interstate Banking and Branching Efficiency Act § 44, 108 Stat. at 2343. President Clinton also signed the Riegle-Neal Amendments Act of 1997 which gives host state law control over state bank interstate branches to the same extent host state law controls national bank interstate branches. Additionally, the Amendments Act allows state bank interstate branches to engage in activities allowed under their home state charter to the extent that those activities are permitted either for national bank interstate branches or for state-chartered banks in the host state.

Kentucky opted into the Riegle-Neal interstate branching provisions effective June 1, 1997. See K.R.S. § 287.920 (Michie 2001). An out-of-state bank may acquire a Kentucky branch or branches by merger or consolidation with an in-state bank provided that the in-state bank has been involved in operation for a period of five years or more prior to the acquisition. Kentucky opted out of "de novo" branching; out-of-state banks may not open "de novo" branches in Kentucky. Riegle-Neal Interstate Banking and Branching Efficiency Act § 103, 108 Stat. at 2352. No interstate merger or consolidation is allowed if the transaction would result in a bank holding company having control of banks or branches in Kentucky holding more than fifteen percent of the total deposits and member accounts in the offices of all federally-insured depository institutions in Kentucky. K.R.S. § 287.920(4).

converting banks in states other than the resulting home-state into interstate branches. Further, it allows out-of-state banks to open branches in new states (where allowed) or to acquire banks in new states through merger or consolidation and convert their branches into interstate branches of the acquiror.

The Riegle-Neal Act created a great deal of controversy among the states, particularly in the area of taxation. Most states' fiscal systems had traditionally been geared to banks located within the state borders, regardless of whether they were owned by home-state interests or out-of-state banking organizations or holding companies. With the onset of interstate branching, the states were concerned about retaining the same level of tax revenue. To allay some of those fears, § 111 of the Riegle Neal Act provided the following assurances:

No provision of this title . . . and no amendment made by this title to any other provision of law shall be construed as affecting in any way—

(1) the authority of any State or political subdivision of any State to adopt, apply, or administer any tax or method of taxation to any bank, bank holding company, or foreign bank, or any affiliate of any such bank, bank holding company, or foreign bank, to the extent that such tax or tax method is otherwise permissible by or under the Constitution of the United States or other Federal law;

(2) the right of any State, or any political subdivision of any State, to impose or maintain a nondiscriminatory franchise tax or other nonproperty tax instead of a franchise tax in accordance with section 3124 of title 31, United States Code; or

(3) the applicability of section 5197 of the Revised Statutes . . . or section 27 of the Federal Deposit Insurance Act. . . .²²²

Despite the savings provisions in § 111, Riegle-Neal's authorization of interstate branching presented serious problems to Kentucky's continued ability to raise revenue through the bankshares tax. Kentucky's bank tax regime was founded on the property taxation of bankshares of Kentucky domiciliaries and Riegle-Neal created the potential for "disappearing bank stock." The state bankshares tax was levied upon the stock of banks domiciled in Kentucky. Localities similarly levied local taxes on the stock of banks headquartered in their jurisdiction. If a bank was no longer headquartered or domiciled in the state, the stock was not taxable to the

²²² Riegle-Neal Interstate Banking and Branching Efficiency Act § 111, 108 Stat. at 2365.

bank. Upon the conversion of a Kentucky bank subsidiary to a Kentucky branch, the domicile of the bank would be transferred out-of-state and the taxable shares of stock would disappear. To avoid the exportation of Kentucky's state and local bankshares tax base, the General Assembly, in 1996, replaced the bankshares tax with the bank franchise tax. The new franchise tax is designed to reach in-state branches of banks headquartered in other states.²²³

B. Deposits Taxes

Prior to the 1996 legislative changes, Kentucky levied a state ad valorem tax on intangible personal property, which includes bank and trust company deposits, at the rate of \$0.25 per \$100 of fair cash value.²²⁴ The statute effectively lessened the amount of tax upon "deposit[s] in any bank, trust company, or combined bank and trust company organized under the laws of this state, or in any national bank of this state."²²⁵ For in-state accounts the rate was lowered from the \$0.25 per \$100 of fair cash value²²⁶ to 0.001% on the amount of the deposit.²²⁷

Depositors were required to list for taxation any money on deposit with out-of-state banks annually on the assessment date. Deposits at in-state banks were required to be listed by the banks themselves.

This bifurcated treatment of deposits was unsuccessfully challenged in 1940. In *Commonwealth v. Madden's Executor*, an administrator of the estate of a Kentucky resident challenged the rate applied to certain deposits held by the decedent in out-of-state banks.²²⁸ At the time, Kentucky taxed deposits in out-of-state banks at \$0.50 per \$100 of value and deposits in in-state banks at \$0.10 per \$100 of value.²²⁹ The estate challenged the rate differential as violating the equal protection, due process and privileges and immunities guarantees of the Fourteenth Amendment.

The case was appealed from the former Kentucky Court of Appeals to the U.S. Supreme Court in *Madden v. Kentucky*.²³⁰ Applying a rational basis standard, the Court upheld the rate differential on the basis that collection

²²³ K.R.S. § 136.530.

²²⁴ *Id.* § 132.020(1).

²²⁵ *Id.* § 132.030.

²²⁶ *Id.* § 132.020(1).

²²⁷ *Id.* § 132.030(1).

²²⁸ *Commonwealth v. Madden's Ex'r*, 97 S.W.2d 561 (Ky. 1936).

²²⁹ *Id.*

²³⁰ *Madden v. Kentucky*, 309 U.S. 83 (1940).

of taxes on out-of-state deposits was more difficult and expensive, therefore justifying the differential. Further, the Court held that "the right to carry out an incident to a trade, business or calling such as the deposit of money in banks is not a privilege of national citizenship."²³¹

Despite *Madden*, a class of taxpayers holding bank deposits in out-of-state banks brought another challenge to the rate differential over fifty years later. The taxpayers in *St. Ledger v. Kentucky Revenue Cabinet* challenged the tax levied on their out-of-state deposits not only on equal protection principles, but also under Commerce Clause.²³² In 1995, the Kentucky Supreme Court dismissed the equal protection challenge on the basis that *Madden* was dispositive and controlling on the issue.²³³ However, the court found that the taxing scheme violated the protections afforded under the Commerce Clause. Deposits made by Kentucky residents in banks located out-of-state were held to be interstate transactions and therefore subject to the protections of the Commerce Clause. Because the rate on out-of-state deposits exceeded the rate on in-state deposits, the taxing scheme facially discriminated against interstate commerce by providing a direct commercial advantage to local business.²³⁴ The litigation did not end until 1997 when the U.S. Supreme Court vacated the Kentucky Supreme Court's opinion.²³⁵

Before the U.S. Supreme Court acted, however, the Kentucky General Assembly acted on the Kentucky Supreme Court's ruling. When the General Assembly convened in early 1996 it had real cause for concern that the courts would ultimately extend the higher tax rate on out-of-state deposits to in-state deposits.²³⁶

X. HOUSE BILL 416 (1996)— BANK FRANCHISE AND LOCAL DEPOSITS TAX ACT

To address the various problems confronting Kentucky's system of bank taxation, the General Assembly during its 1996 Regular Session

²³¹ *Id.* at 92-93.

²³² *St. Ledger v. Kentucky Revenue Cabinet*, 912 S.W.2d 34 (Ky. 1995), *vacated*, 521 U.S. 1146 (1997).

²³³ *Id.* at 38.

²³⁴ *Id.* at 42.

²³⁵ *St. Ledger v. Kentucky Revenue Cabinet*, 521 U.S. 1146 (1997).

²³⁶ See *McKesson Corp. v. Div. of Alcoholic Beverages and Tobacco*, 496 U.S. 18, 32-41 (1990) (requiring states to provide backward looking relief for the payment of unlawful taxes). One option available to the courts under *McKesson* to remedy the unconstitutional discrimination against out-of-state deposits would be to retroactively assess in-state deposits additional tax to result in a nondiscriminatory scheme.

enacted the Bank Franchise and Local Deposits Tax Act (the "Act").²³⁷ The Act repealed the state and local bankshares taxes and replaced them with state and local bank franchise taxes. Also, the Act corrected the rate inequity under the deposits tax.

Effective July 15, 1996, "financial institutions" regularly engaged in business in Kentucky are subject to the new state-level bank franchise tax. The tax is levied on the privilege of transacting business in Kentucky at a rate of 1.1% on the financial institution's net capital or apportioned. All bank franchise tax revenues are deposited in the General Fund. The state-level bank franchise tax has a twofold purpose. First, the new tax is an attempt to modernize and standardize the state taxation of Kentucky banks and other financial institutions. Second, the bank franchise tax is a clear attempt to extend Kentucky's taxing jurisdiction to banks and other financial institutions that realize income from Kentucky sources but were not (or would not have been) subject to the bankshares tax.

To correct the unconstitutional rate differential applicable to bank deposits, the Act also makes two major changes to the Kentucky deposits tax regime. First, the state ad valorem tax rate applicable to deposits held by banks is equalized. An intangible personal property tax of \$0.001 per \$100 of value is assessed on funds on deposit in any financial institution.²³⁸ No other ad valorem property tax is assessed by the state or any county, city, or other taxing district against the depositors.²³⁹ Second, cities and counties are authorized to levy a *franchise tax* on banks which is measured by deposits held in branches within their jurisdiction.²⁴⁰

All financial institutions are required to list and pay taxes on their taxable deposits on behalf of their depositors. Every financial institution which holds a deposit which is taxable in the name of the depositor "under the laws of this state" must file a deposits tax return. The reporting and assessment of the state and local deposits taxes are administered by the Revenue Cabinet.²⁴¹ Only the applicable tax rate is determined locally.²⁴²

²³⁷ 1996 Ky. Acts 254, at 999 (codified at K.R.S. §§ 136.500-.990).

²³⁸ K.R.S. § 132.030(1).

²³⁹ *Id.* § 132.030(2).

²⁴⁰ *Id.* § 136.575. The location of deposits for purposes of this local deposits tax is to be determined by the "method used" for filing the summary of deposits report with the Federal Deposit Insurance Corporation. *Id.* § 136.575(2).

²⁴¹ *Id.* § 136.575(3)-(5); *id.* § 132.040(1).

²⁴² *Id.* § 136.575(2). Cities and counties may levy the local franchise tax on financial institutions at a rate not to exceed 0.025% of the deposits located within the taxing jurisdiction. Urban-county governments may levy the local franchise tax at a rate not to exceed 0.050%. *Id.* If both a city and a county levy the local franchise tax, it appears that the taxes are cumulative; the city tax may not be

In designing the local franchise tax, the drafters of House Bill 416 sought to make the tax revenue neutral on the local level. It appears, however, that House Bill 416 has been a substantial revenue raiser for Kentucky's cities and counties.

Under the bankshares tax, cities and counties were authorized to tax banks on the value of their bankshares *if the bank was located in the city and/or county*.²⁴³ In short, a city or county could tax the bankshares only if the bank was headquartered or domiciled in the city or county. Cities and counties having only branches but not the headquarters could not levy a tax on the bank's shares.

The local franchise tax, however, significantly expands the breadth of local taxation of financial institutions. Cities and counties may tax deposits located in their jurisdictions as provided on call reports. Thus, cities having branches but not headquarters may levy the franchise tax. Assuming that the local franchise tax is revenue neutral, this would mean necessarily that cities and counties which serve as the headquarters of banks with branches outside their boundaries would lose revenue from the repeal of the local bankshares tax while cities and counties with branches would gain revenue under the local franchise tax. However, anecdotal evidence appears to contradict this assumption. It was reported that in 1996, the city of Louisville derived \$1.2 million from the local franchise tax, roughly the same amount the city received under the bankshares tax the prior year.²⁴⁴ Jefferson County, however, received \$2.1 million in 1996 which was \$200,000 more than it received from the bankshares tax the prior year.²⁴⁵

The revenue projections used in designing the local franchise tax assumed that only those local jurisdictions which had derived revenue from local bankshares taxes would levy the new tax. Quite the contrary, cities and counties which derived no revenue from the local bankshares tax have since levied the local franchise tax on branches within their districts, resulting in a substantial increase in public revenue at the local level. The *Courier-Journal* reported the following response to the 1996 enabling legislation for the local bank franchise tax:

In principle, there's nothing wrong with the tax, which replaces a tax on bank shares. For the city of Louisville, for instance, the new tax on

credited against the county tax.

²⁴³ See *id.* §§ 91.620, § 132.200(7), amended by 1996 Ky. Acts 254, at 999.

²⁴⁴ Scott Wade, *Council May Repeal New Bank Tax*, *COURIER-JOURNAL* (Louisville, Ky.), Dec. 19, 1996, at B2.

²⁴⁵ *Id.*

bank deposits will generate about the same amount of revenues as the old tax did—\$1.2 million.

But a number of smaller municipalities that used to collect no taxes on bank shares—because no bank headquarters were located within their city limits—are now rushing to cash in on the deposits tax. And in some cases they concede they have no particular use for the money. The city attorney of Jeffersontown, for instance, says the city may use the \$50,000 to \$100,00 in new revenues to roll back property taxes.²⁴⁶

Articles in the *Courier-Journal* also reflect the surprise of bankers over the wide-spread popularity local bank franchise taxes enjoyed with smaller cities. While the Kentucky Bankers Association helped lobby the enactment of this broader source of local revenue, the bankers actually tried to discourage many suburban cities from levying the local franchise tax. One article stated that “[t]he state Revenue Cabinet calls the new tax ‘revenue neutral,’ but bankers have argued that it becomes an add-on tax when cities that didn’t tap into the previous tax before begin to adopt this one.”²⁴⁷

Another article sums up the response of bankers over local tax changes made in the aftermath of the Bank Franchise and Local Deposits Tax Act. The article summarized conversations with various bankers as follows:

The irony here is that the Kentucky Bankers Association supported creation of the deposits tax. Without it, cities that had depended on the bank shares tax would have been hard hit, since the latter tax was in effect eliminated by a change in federal law.

*They say that no good deed goes unpunished. The bankers are getting a bum deal.*²⁴⁸

XI. CONCLUSION

The first 124 years of the banking industry in Kentucky were marked by repeated attempts to bring the industry into the general property tax regime and constant litigation over the disparate treatment of state and national banks. Since the inception of national banking, Kentucky’s state and local governments have been on the defensive. The state’s initial reaction to national banking was to create a special tax regime for national banks, one that differed substantially from that of state banks. This

²⁴⁶ *Forum: Bank Shot*, COURIER-JOURNAL (Louisville, Ky.), Nov. 30, 1996, at A10.

²⁴⁷ Wade, *supra* note 244.

²⁴⁸ *Forum: Bank Shot*, *supra* note 246 (emphasis added).

divergence generated constant litigation initiated by either the banks or the state and local taxing authorities. It was not until 1924 that Kentucky ended its bifurcated bank taxing system, establishing equal tax treatment for all financial institutions and a peaceful equilibrium.

Congress disturbed this equilibrium in 1994 with the enactment of the Riegle-Neal Interstate Banking and Branching Efficiency Act. Kentucky taxpayers also dealt a serious blow to the bank tax regime by successfully challenging the constitutionality of the bank deposits tax in the *St. Ledger* litigation. Consistent with past practice, the General Assembly has once again responded. Far from maintaining the status quo, it appears that the Bank Franchise and Local Deposits Tax Act of 1996 represents a substantial broadening of state and local taxing authority over financial institutions, as well as a sizeable increase in the local tax burden borne by banking institutions. Whether equilibrium has been restored will be tested as the banking industry reorganizes itself in light of its newfound opportunities.